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**THE CONTRIBUTION OF ISLĀMIC BANKING
TO ECONOMIC DEVELOPMENT:
THE CASE OF THE SUDAN**

by

Osman Babikir Ahmed

A Thesis submitted in fulfilment of
the requirement for the degree of
Doctor of Philosophy

The University of Durham
Department of Economics
November 1990



- 4 OCT 1991

Dedication

To :

My mother, Asia, the great giver.

Abstract

The central objective of this research is to assess the contribution of Islāmic banking to the development of the Sudanese economy. Having operated for nearly a decade and a half, Islāmic banks in the Sudan, as in other countries, are under scrutiny for their role in financing development.

Critics as well as proponents of Islāmic banks are questioning the role of Islāmic banks in extending credits to real productive sectors. Criticisms were made that Islāmic banks have been concentrating on short-term (and trade) finance and have done little to promote long-term (and equity) finance.

The research findings show that the contribution of Islāmic banks to development financing is insignificant. There are different factors affecting this role, such as the character and strength of demand for financing productive projects, the attitude of the Islāmic banks managements, government policies, and the structural rigidities characterising the Sudanese economy.

As for the first factor, the research findings show that for investors of Islāmic banks, the following elements affect their decision to demand credit: repayment period, grace period, profit margins and the type of guarantee. Islāmic banks specify these elements as conditions for obtaining credit. The fieldwork findings reveal that the repayment and grace periods are too short and that profit margins are high, which discouraged customers from applying for credit. Thus demand was affected, especially demand for medium-and-long-term investments.

On the other hand, borrowers themselves refrained from applying for credit for productive investments and tended instead to go for trade finance. There are two reasons for customers' preference for trade finance rather than productive loans: customers are not prepared to take risk and they lack adequate capital. Therefore

the attitude of customers in this regard is characterised by the low demand for medium-and-long-term investments and the high demand for short-term or trade finance.

The attitude of Islāmic banks' managers is not conducive to medium-and-long-term investments. The concentration on borrowers in urban areas; the great emphasis on collateral without differentiating between the nature of the proposed projects; the shifting of resources from rural to urban areas, all these and other factors influence Islāmic banks managers to sponsor productive investments.

So far as the effect of public policies on the role of banks in economic development is concerned, policies have negatively affected this role. The government policies have been consistently protectionist, and therefore bankers in particular, and industrial entrepreneurs in general, have adopted conservative behaviour.

Of course, it is not only the attitude of authorities which has affected the contribution of all banks to the financing of productive projects; structural problems of the Sudanese economy have also hampered the role of banks in this regard. For managers of Islāmic banks, uncertainties surrounding productive investments are high, especially given the nature of the Sudanese economy.

The role of Islāmic banks has also been assessed in terms of their contribution to the monetisation of the economy. In this regard, their role is found to be encouraging.

Islāmic banks were able to attract new clients and to convince others who had already banking relations with conventional banks to deal with them. The logical step for Islāmic banks to maintain their fairly good share in the deposit market is to build on their relationship with customers. This should be done by satisfying customers' needs and requirements. These motives were listed as: religiously permissible (interest-free) transactions, competitive (high) rates of return on investment deposits, the great access to banking credit facilities, competitive services and a wide spread of services.

However, the research findings show that the religious element is ranked first in importance for customers. The competitive service and wide spread of services ranks after the religious element. Thus customers deal with Islāmic banks basically

for these three reasons. One finding which is unfavourable for Islāmic banks is that customers were not attracted by high returns or by greater access to credit facilities.

Financial facilities provided by the commercial banks, and the pattern of allocating these facilities provide evidence that smaller firms in the Sudan are at a disadvantage in terms of type, volume and conditions of financing. Thus, commercial banks contributed partly to the smaller business finance gap in the Sudan. Banks have been highly security-conscious and profit-oriented.

Financing practices of even the development financial institutions violated the main objective of setting up these development bodies as they have been, as well, both security-conscious and profit-oriented.

Regarding the financial institutions policies, there is a small business 'policy gap'. In addition to this, there is found to be lack of information and advice about the financial facilities available in the banking system.

The Faisal Islāmic Bank initiated financial assistance to small firms. This experience is fruitful, but it needs a thorough-going evaluation. Such an evaluation was one aim of the study, so that banking credit could be directed more effectively to the small crafts sector in order to enhance economic growth.

Crafts firms face a finance gap, and information and advice gaps. Of particular importance is the finance gap. The crafts branch of Faisal Islāmic Bank (Sudan) has helped in bridging part of this gap, but still the crafts sector is under-financed. The cause for this has been tackled with regard to the conditions stipulated for credit extension by the branch. An empirical investigation proves that with the exception of 'grace period condition', other stipulations are flexible and have not influenced craftsmen in deciding to increase credit.

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Declaration

I hereby declare that this thesis entirely results from my own investigation, and that no part of it has previously been submitted for any degree at this University or any other university,

Signed

Osman Babikir Ahmed

The Supervisor

Dr. Rodney J. A. Wilson,

Chairman of the Board of Studies

Department of Economics

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I'm responsible for any errors that remain.

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Chapter I

Introduction

1.1 Islāmic Banks: A Brief History

Islāmic banks (IBs) differ from other banks operating in Muslim countries by virtue of their rejection of the conventional banking practices of charging interest on loans and paying interest on deposits. The levy of any fixed charge on the use of money is viewed as *riba*, or usury. Like other financial intermediaries, however, IBs make profits by putting the savings of investors at the services of borrowers. Instead of charging fixed rates to borrowers, they share in the profits – and losses¹ – of the borrowers' business transactions, and divide their share of the profit with investors who have deposited funds in the bank. Rates of return, calculated *ex post facto*, are variable, depending on a whole complex of business transactions rather than on a predetermined fixed rate that would be tantamount to interest.

The 19th and the 20th centuries witnessed the triumph of the West over the Muslim world. The radical changes which were accompanied by a decline in the power of the social order of Islām to control Muslim life. A new set of secular norms and Western-inspired cultural, political and socio-economic development programmes were imposed as an alternative to the common set-up and heritage rooted in the consciousness of Muslim societies throughout their history.

However, since the main focus of this study is the contribution of Islāmic banking to economic development, only the economic and financial aspects are relevant in this regard. In both the pre- and post- colonial periods, the idea which spread among rulers and elites of Muslim societies was that the strategy of socio-economic development should be adopted within a secular framework. In particular, the capitalist (and socialist) economic approach should be followed.

In this concern, by far the most significant event has been the introduction of the interest-based banking system– i.e. *riba*-based banking– into Muslim societies.

¹ A system called the profit-and-loss sharing system (*PLS*).



Riba-based banking is a product of Western socio-economic and religious development, with its roots in medieval commercial practices. It was in fact part of the naturalistic (secular) protest against the medieval church which had hitherto stood firm against the practice of usury.

The rise of *riba*-based banks in the Muslim world gave rise to controversy over the legitimacy and permissibility of interest as well as other transactions performed by these banks. The controversy absorbed the attention of Muslim scholars and stood as a critical test for the Muslim masses to prove their loyalty to their religion (Mallat, C., 1988). More decisive and important was the response of the Muslim jurists. Despite all the efforts to find an excuse for justifying the use of interest, it was denounced by the majority of Muslim scholars as *riba* to be prohibited in all forms as well as under all circumstances.

However, for more than half a century the debate of Muslim jurists concentrated only on the prohibition of *riba* and the permissibility of profit via trade, which is allowed according to the *Qurā'n* and the *Sunna*. There was no practical alternative to the interest-based banks.

The first attempt to establish an interest-based bank in the Muslim world came in Pakistan in the late 1950s, (Wilson, R. J. A., 1985). A braver and more important move in this direction was the constructive experiment of the Myt Ghamr rural saving banks which started in Egypt in 1963. These and other early attempts notwithstanding, the development of the modern Islāmic banking movement started as recently as 1975 (see Chapter IV). Within a decade, the Islāmic banking movement had achieved an impressive growth. From a single Islāmic bank in 1975, the number of banks and financial institutions operating on an interest-free basis is currently not less than fifty. In addition to the Sudan, where 6 out of 24 operating banks are Islāmic, two Muslim countries – Iran and Pakistan – have already made their financial systems interest-free.

Arguably, the most salient feature of the development of Islāmic banking is its inception and operation in some non-Muslim countries such as England, Switzerland and the Bahamas. Not less impressive is the initiative taken by a number of interest-based banks in both Muslim and non-Muslim countries to open sub-branches and divisions for 'interest-free dealings'.

The relationship between IBs and the financial and monetary authorities in the countries in which they work is still unclear. Despite the restrictions imposed on this kind of banking activity, the IBs progressed steadily in their early years. In fact their rapid growth has been not only in terms of number, but also in terms of the size of their assets.

To conclude, it can be said that interest-free banks are now a reality and not just a theoretical response to the issue of interest. The existence of IBs is evidence of the fact that 'financial interest-free' dealings could come about in practice. Moreover, the phenomenon of interest-free banks has enriched the economic literature, for there have been many works written on the issue of Islāmic financial theory.

As they become a reality, IBs face important issues concerning their development. These unsolved issues might detract from the urgent need of these banks to formulate a comprehensive strategy. The need for a strategy is highlighted by the fact that IBs are not simply financing institutions as other banks are; they are banks with a mission. As Howaidi put it

'Islāmic banks are missionary in the sense that they should perform the task of Islām as they depend on a religion with its own moral rules and rightness' (Howaidi, F., 1988).

The need for a strategy could be justified as follows:

(i) IBs do not seek to satisfy the banking needs of their customers within the framework of the official monetary policies as traditional banks do. Rather they aim at restructuring the banking needs of their customers, re-stating the deposit-bank-borrower relationships, and reshaping monetary policies and institutions. These changes cannot be achieved instantly and the process may take a considerably long period of time. Thus there is a need for a strategy which can govern and guide the course of change, preparing IBs for a new phase of expansion and consolidation, (Awad, M. H., 1988).

(ii) The IBs movement has been recognised by the banking community, governments, international financial institutions and academic circles, inside and outside the Muslim world.

The tenets of Islāmic finance from which Islāmic banking is derived have been

recognised by international financiers, particularly after the recent development in the debt crisis. Moreover, the poor stock market performance since October 1987 has demonstrated to the shareholders and dealers that even this form of investment can be adversely affected by high interest rates, which can disrupt the entire financial system. Even the usurers have come to realise that, with inflation rates exceeding the interest rates they charge, they have become the victims of interest charging while their debtors are the gainers; had they followed Islāmic methods of finance, which are subtly inflation-indexed, they would have been markedly better off. Similarly, Muslim investors in the world capital market have suffered from both inflation and exchange rate fluctuations, two hazards against which the Islāmic system of finance would have insured them.

All these developments bring to the Islāmic banking movement a substantial number of opportunities within the Muslim world and beyond, and call for co-ordinated and sustained efforts on behalf of all its constituent banks.

1.2 Motives of the study

After almost a decade and a half, IBs are at a turning point. When first launched in the mid-1970s and early 1980s, IBs made large initial profits, although their performance deteriorated in the mid-1980s. Some writers have attributed this to the economic recession in the Gulf which reduced imports into the region (Moore, C., 1990). Because IBs are more dependent for revenues on short-term trade financing than are most commercial banks, they suffered more from the recession.

However, this point raises the question of the contribution of IBs to the development of real productive sectors rather than trade sectors. In other words, it raises the questions about the distribution of IBs' funding activities between the medium-and-long-term investments and short-term investments, i.e. trade finance.

The question of the IBs' contribution to assist developing the economies in which they work is also examined, given the recommendations of the General Conferences of IBs. At the first conference of IBs held in Turkey in 1986 the main recommendations of the conference included:

(1) Comprehensive development encompassing all of the Muslim world and transforming both its economy and society along Islāmic lines;

(2) Creation of a modern and efficient banking system based on Islāmic principles of finance, together with the flexible adoption of international banking innovations that comply with these principles;

These and other goals are to be achieved by:

- Formulation of plans and phased programmes;
- Formulation by IBs of affiliated development companies to furnish medium-and-long-term finance to investors;
- Transformation of the International Association of Islāmic Banks (IAIB) into a central planning organ for all IBs, and vesting it with certain executive powers for implementing approved plans;
- Creation of supportive services and facilities including a joint trust, a secondary market for securities, a re-insurance organ and training centres;
- Establishment of a feasibility study and project promotion unit for the preparation and propagation of investment projects of particular importance.

The second conference of IBs was held in Sudan in 1988. It confirms again the fact that:

(1) IBs should participate actively in achieving balanced economic and social development, concentrating on providing the basic needs of the societies, and giving special attention to the backward areas of the countries in which they work and to less developed sectors of the economies of these countries;

(2) Spreading and developing savings and investment knowledge among the general public in order to mobilise as much finance as possible and re-invest these mobilised savings to help in the development of a proper economic base;

(3) Concentrating on medium-and-long-term allocation of resources in different economic activities;

(4) IBs should seek to improve their performance in order to provide competitive services and allocate the available resources optimally;

(5) Encouraging the financing of small craft firms, farmers and co-operatives.

Accordingly, the main focus of this study will be the role of the Sudanese IBs in development financing. In particular, there shall be a concentration on the contribution of the IBs to economic development at the following levels:

Firstly, at the level of savings mobilisation, it will cover the spread of Islāmic banking services, especially in rural areas, the structure of their deposits, and the nature of the liability side. In other words, their role in the process of monetising the Sudanese economy will be appraised.

Secondly, at the level of financing productive sectors, and in this regard it will show the size of finance directed by IBs to sectors such as agriculture, industry and other real sectors.

Thirdly, as part of the contribution to development financing, the volume of Islāmic credit deployed in the small crafts sector will be investigated, especially the Faisal Islāmic Bank (Sudan) (FIBS), the leading bank in the Sudan which has initiated the financing of this vital sector.

Therefore, an empirical study based on the experience of Islāmic banking in the Sudan will be carried out as an essential part of this work. The experience of IBs in the Sudan is chosen for the following reasons:

- The Sudan has more IBs than any other Islāmic country. As mentioned above, out of 24 operating banks in the Sudan, 6 are Islāmic. Moreover, in terms of the banking clienteles or market share, the Sudanese IBs have nearly 20% of banking deposits, and 60% of the paid-up capital of the Sudanese commercial banks.
- Among all Arab and Muslim countries, the Sudan has greater potential for growth in productive sectors, especially agriculture, industry and agro-industries. This potential has not yet been utilised, partly because of the lack of capital. Like other financial institutions, IBs are expected to contribute to the provision of development financing.

- Islāmic banking is well established in Sudan, with FIBS, which was the first Islāmic bank to be established in the Sudan (in 1978), among the top 100 Arab banks alongside with the Faisal Islāmic Bank of Egypt and the Kuwaiti Finance House (Moore, C. H., 1990).
- The Sudanese economy is closely linked to international financial institutions such as the IMF and the World Bank. Since 1978 the economy has been run according to the policies prescribed by the IMF and the performance of the economy was totally different before and after the implementation of these policies (see Chapter V). In general, the IMF policies are basically dependent on credit control, and it will be interesting to see whether this affects the role of IBs in the Sudan in the provision of medium-and-long-term financing.
- As seen before, the first and the second conferences of IBs recommended that the financing of small craft firms be encouraged. FIBS, the first and leading Islāmic bank in Sudan, has initiated the provision of loans to small craftsmen in the Sudan. Thus the financial assistance of small crafts units as experienced by FIBS needs close investigation in order to determine the contribution of the Sudanese IBs to development financing.
- Records of commercial banks in the Sudan reveal that they limit their fund-raising and lending activities to urban areas, extending only limited banking services to rural areas (see Chapter VI). Thus, the legitimate question is whether the Sudanese IBs have repeated the same thing, or whether they have expanded their services to the desperately needy rural areas. In other words, what is their contribution to the monetisation of a backward economy such as that of the Sudan, where the traditional sector is still dominant?
- Do IBs in the Sudan depend on the religious motive of clients to deal with them or are they competitive enough to attract and satisfy customers' interest and so maintain their market share?
- IBs started in the Sudan in 1978 with special laws; the first Islāmic bank, FIBS, was granted certain exemptions and concessions. However, in 1984 there was a big change in government policy towards IBs, and since then it might be said that there has been some sort of biased public policy towards these banks. Has

this change in public policy affected the performance of IBs, and in particular their contribution to development financing?

- Despite government encouragement, since 1984, IBs in the Sudan have continuously come under severe attack from both officials and the public at large, which accuse them of concentrating on short-term (trade) rather than medium-and-long-term (equity) finance.
- The performance of the Sudanese IBs is of special concern to the author, who was formerly an official with the Taḍāmon Islāmic Bank (Sudan). He worked there in different divisions of the investment department for two and a half years. He is now an official at the researches and statistics centre of FIBS.

1.3 Hypotheses

In the light of the above explanation, the following hypotheses can be put forward:

- The contribution of the Sudanese IBs to development financing is still insignificant.
- Their contribution is largely affected by the public authorities' attitude towards these banks and by the attitude of IBs' managers themselves.
- Though better than other commercial banks, the Sudanese IBs still concentrate on an urban clientele. Rural areas, where the informal money market with its characteristic feature of extravagantly high interest rate is dominant, are deprived of banking services.
- Despite the fact that they are just as competitive as other commercial banks, IBs in the Sudan still depend on the religious motives of their clients; in the long-run this might endanger their market share and therefore their existence.

1.4 Objectives

This study aims to achieve the following objectives:

- To examine the general framework of Islāmic economics, the opinion on the issue of the interest rate both in theological and philosophical schools of thoughts, and to discuss interest and profit in economic theory.
- To give a brief historical background on the growth of Islāmic banking, to explain the methods of finance they use, and to explore unsolved issues concerning and affecting the process of development of these banks.
- To examine the wider environment within which IBs work, i.e. the Sudanese economy, and the narrower and more important environment, i.e. the financial and monetary structure of the Sudanese economy, and its impact on the performance of IBs in the Sudan.
- To assess the overall contribution of IBs to development financing and the monetisation of the economy. The prime concern of this assessment will be to reveal whether or not the insignificant contribution of IBs to development financing can be attributed to: (a) the attitude of the public authorities; (b) the attitude of IBs managers; (c) the attitude of customers; or (d) the nature of Islāmic methods of finance.
- One of the most important objectives of this study is to assess the experience of the leading Islāmic bank in the Sudan, FIBS, in financing the small craft firms. This is an important issue not only in the Sudan, but also in developed countries such as Great Britain and the United States. The concern here is primarily to see whether there is a finance gap facing smaller craftsmen in the Sudan, and to ascertain the role of FIBS in bridging this gap and other 'information and advice' gaps.
- To reach a comprehensive conclusion and propose recommendations based on the findings of the research.

1.5 Methodology and Procedures

The methodology adopted for this study has two main aspects:

- The theoretical aspect, which involves two major steps:

(i) The collection of material on economics in general, and Islāmic economics and Islāmic banking in particular, from various sources inside the Sudan and elsewhere.

(ii) Use of the available material to analyse the theoretical aspect of the working mechanism of Islāmic banking.

- The empirical aspect, which involves the following:

(i) Examination of the characteristic features of the Sudanese economy in general and the financial and banking sector in particular. This will be done by referring to the secondary data on the subject, e.g. works of references, dissertations, official reports and other publications.

(ii) Analysis of the funding and lending activities of IBs in the Sudan. This is actually in two different, but complementary, parts. The first is an assessment of the performance of IBs in general; the second is an assessment of the experience of FIBS in funding small crafts firms. For this purpose, the following procedure will be adopted:

(a) The secondary data will be analysed through a study of the annual reports and publications and private reports of IBs.

(b) The primary data² will be analysed as follows:

(i) A questionnaire will be conducted with depositors who keep different accounts with IBs.

(ii) A questionnaire will be conducted with investors, those who take loans from IBs.

(iii) Managers of the Sudanese IBs will be interviewed.

(iv) Some officials from the Central Bank of Sudan, the Ministry of Finance (Sudan) and those in the Ministry of Industry (Sudan) will also be interviewed.

² The author collected data from the Sudan during the fieldwork tour over the period January-April 1989 (see Chapters VII and VIII). Another set of data was collected on craftsmen funded by FIBS (see Chapters X and XI).

(c) The experience of FIBS in financing smaller craft businesses will be assessed by:

(i) First, analysing the secondary data on the small-scale industries (SSIs) in the Sudan, the finance gap facing these firms, and the role of financial institutions to bridge that gap. An assessment of small crafts by FIBS involves an exploration of the literature on small-scale business financing, and the application of the notions of the small firms' 'finance gap' and 'information and advice gaps' to the Sudan. This also entails an overview of the setting-up of SSIs in the Sudan in general (see Chapter X).

(ii) Analysing the secondary data provided from FIBS' reports and the reports and files of the crafts branch.³

(iii) Analysing the primary data on the smaller craftsmen and their experience with FIBS (see Chapter XI).

1.6 Scope and limitation

The scope and content of this study should be seen in the light of the following:

The author has tried to depend mainly on the primary data collected through the fieldwork by distributing questionnaire forms to depositors who keep accounts with IBs, investors who borrow money from IBs, craftsmen who deal with the crafts branch of FIBs, and managers of IBs. However, due to time constraints and prohibitive costs, it was not possible to reach customers outside urban areas in the Sudan.

The secondary data depended on the annual reports of IBs, the Bank of Sudan, the Ministry of Finance (Sudan) and the Ministry of Industry (Sudan), and other economic institutions (in the public and private sectors). However, data from these sources are in many aspects inconsistent and incomplete. Accordingly, the research may suffer from these limitations, although the data from secondary sources have been treated with caution in the light of their inconsistency and inadequacy.

³ The specialised branch set-up by FIBS as a separate branch to supervise and fund smaller crafts units.

1.7 Format of the Study

This research is divided into twelve chapters. The first chapter is an introduction to the study. It provides a background to the problem and explains the purpose and methodology of the study. The second chapter is a broad introduction to Islāmic economics and the notion of *riba* from the theological and philosophical point of view. In particular, it compares the phenomenon of *riba* in both Christianity and Islām. Chapter III discusses the notions of interest and profit in economic theory. The old and modern forms of profit-sharing system, as an alternative to the interest rate institution, are also identified in this chapter. Addressing the Islāmic solution to the problem of *riba*, the theoretical and practical development of banking is examined in Chapter IV.

The practical part of this work begins with Chapter V, which reviews the structure and development performance of the Sudanese economy. The financial and banking aspects of the economy and their development are discussed in Chapter VI.

The remaining part of the thesis is the central part of the study, in which the author has attempted a comprehensive appraisal of Islāmic banking in the Sudan. Chapter VII discusses the problems and prospective development of the Sudanese IBs. It gauges the role of IBs in the monetisation of the Sudanese economy and discusses some of the problems of these banks. An evaluation of the performance and contribution of IBs to development financing in the Sudan is carried out in Chapter VIII. These two chapters constitute the first part of the fieldwork on the overall contribution of IBs to economic development in the Sudan.

Chapter IX tackles the workings of FIBS while Chapter X covers the theoretical aspects of small firms financing and applies the notion of a small business finance gap, and other gaps, to SSIs in the Sudan. Chapter XI is an assessment of the financial assistance given by FIBS to crafts firms in the urban area of Greater Khartoum. This chapter is intended to complete the theme about the role of IBs in development financing in the Sudan. It also represents the second part of the fieldwork. The final chapter of the thesis includes the conclusion and the recommendations of the study. The thesis ends with the relevant appendices and the bibliography.

Chapter II

Islāmic Financial Theory And Usury

2.1 The Economic System of Islām

The Islāmic system is dedicated to social and economic justice and the equitable distribution of income, as well as to individual freedom within the context of social welfare. The Islāmic economic system is different from the capitalist and socialist systems in that it is spiritually-oriented; it recognizes material well-being based on spiritual values.

This chapter describes the characteristic features of the Islāmic economic system with regard to its encouragement of economic enterprise, its recognition of private ownership and freedom of enterprise, and the levying of *Zakāt* and other distributive measures as a tool of disbursing wealth to different groups of the society and as a source of finance. It also describes usury according to the religious and philosophical viewpoints.

2.1.1 Desirability of Economic Enterprise

Man's natural desire for economic well-being is duly recognized by Islām. Islām gives man certain rights and adumbrates a social order which ensures collective well-being and the elimination of poverty. A distinguishing feature of the Islāmic economic system is that

'it removes the edge from economic competition and puts human relations on a co-operative basis', (Siddiqi, M. N., 1970, p.115).

Islām highlights the desirable features of economic enterprise. It gives the individual rights of property and freedom of enterprise. It enjoins the fulfilment of contracts and emphasizes justice as a basis of economic relations; it also fixes certain responsibilities on the state relating to social security and economic development.

At the same time, Islām condemns the undesirable features of economic activity and puts certain restraints on the right of property and freedom of enterprise. It seeks to maintain a balance between individual liberty and social interest by laying down certain guiding principles of social policy. According to Islām, all the resources of nature are accessible for use by all so that men might lead a good life. The *Qur'an* says:

'It is we who have placed you with authority on earth, and provided you therein with means for the fulfilment of your life', (Suret A'raf or the Heights, verse 10).

That is, all the material things which are crucial for comfortable life, as well as those powers, faculties and opportunities which are instrumental in elevating human existence to a higher level.

Islām sees wealth as a blessing from the God and considers it a means for living,

'Your property which God has made a means of support for you', (Suret An Nisā' or the Women, verse 5). However, owners of property are not free to do any thing they wish with what they own; their rights are limited by what is useful and good for society. This principle of Islām is reiterated in by the *Sunna*⁴ for the prophet is recorded to have said that

'Wealth is a good help in a righteous living'.

The Islāmic approach to economic enterprise can be understood in the light of the fact that enterprises providing the necessities for life are socially obligatory in the sense that some people must engage in them; if not, society as a whole would suffer. Thus the Islāmic system set great store by economic enterprise for the proper ends. As Baqir al- Sadr says

'The extraction of every particle of usefulness from the entire universe is an ideological objective of the Islāmic society', (Baqer al Sadr, Mohammed, 1968, p. 573).

This is, in this sense, a religious obligation of man on earth, by both ethical teaching and legislation. Modern Islāmic works on economics provide a relatively extensive survey of the texts from the two main sources of Islāmic jurisprudence,

⁴ *Sunna* is the second main source of Islāmic jurisprudence.

the *Qur'an* and the *Sunna*. These texts clarify the Islāmic view of the importance of production and the prohibition of abstention from economic activity, even if this be for the sake of *extra* worship. The legislative means taken by Islām to promote productivity and discourage non-utilization of resources are many. They include: the right of the government to take land away from the private owner if he fails to cultivate it; the strict prohibition of all non-productive activities such as gambling; the imposition of a 2.5% annual tax on money and other mobile assets in order to discourage hoarding; restrictions placed on speculation and the prohibition of mere speculative transactions in both the finance and commodity markets.

Modern Islāmic literature on economics emphasizes the fact that economic activity is necessary for the improvement of not only man's material condition but also his moral outlook. Therefore Islām bans any kind of economic activity which deprives man of his moral values; it also prohibits all the types of industrial activity and relations which degrade man or make him party to vices for the sake of economic gain, (K., Monzer, 1978).

2.1.2 Private ownership & freedom of enterprise

Man is given the right of property and economic enterprise is encouraged for fulfilling proper ends. The free mutual consent of buyer and the sellers is, according to all schools of Muslim jurisprudence, a necessary condition for any business transaction. The only system that would conform to this spirit of freedom in the Islāmic way of life is one where the conduct of the greater part of production and distribution of goods and services is left to individuals or freely constituted groups. Freedom of enterprise and the institution of private property are therefore recognised and accepted by Islām.

The *Qur'an*, *Sunna* and the *fiqh*⁵ literature all discuss in significant detail the norms related to the acquisition and disposal of private and business property and the purchase and sale of merchandise. The institutions of *Zakāt* and inheritance are also considered. These would not have been examined in such detail had the institution of private ownership of most productive resources not been recognized by Islām.

⁵ *Fiqh* is the opinions of Muslim jurists which they derive from *Qur'an*, *Sinna* and other sources of Islāmic jurisprudence.

Any system incorporating freedom of enterprise needs motives. For this reason Islām recognizes profit motives, essential for the successful operation of the system. But since it is possible for profit to become an end rather than a means, thus leading to many bad social and economic repercussions, Islām places certain regulatory and moral restraints on the profit motive to ensure that it fosters individual self-interest within a social context and does not violate the Islāmic goals of social and economic justice and equitable distribution of income and wealth.

The concept of profit maximization is modified in the Islāmic approach because it does not stand as it does in the capitalist mode in relation to the time-horizon and the connotation of success. To simplify an understanding of the goals of the firm, in the Islāmic economy, profit maximization can be used as a fair criterion if it is seen as being constrained not only by cost but also by a minimum level of what is conceived as 'good', guaranteed both by ethical values and legislation. As Abbas puts it,

'Islāmic economic philosophy lays special emphasis on securing a 'fair' factor compensation. The Islāmic concept of fairness combines both its material and its spiritual notions, unlike the non-Islāmic concepts which usually relate fairness to individualistic norms and preferences with no reference whatsoever to non-individualistic or religious factors', (Abbas, A. B. M., 1987, pp. 187-188). Within this context, the process of maximizing profit should not violate the 'rules of the game' of the Islāmic economy.

Islām's acceptance of freedom of enterprise, private property and individual initiative does not mean that the Islāmic system is similar to capitalism. There are several important differences:

Firstly, in the Islāmic system, even though property is allowed to be privately owned, it is considered a trust from God. In other words, private ownership is related intimately to the principle that man is the trustee of God.

Secondly, because man is a vicegerent of God and the wealth he owns is a trust from him, he is therefore bound by the moral precepts of Islām, particularly the criterion of *halāl* and *harām*, (i.e. the permitted and the forbidden), social and economic justice, equitable distribution of income, and the fostering of the common good, (Chapra, M. 'Ūmar, 1979).

Thirdly, the degree of interference of law, whenever this is deemed necessary, is indisputably greater in the Islāmic economy. In the Islāmic economic sphere, there exists a *hisba* agency or market controlling system, in which the market controller (*muhtasib*) is responsible for supervising prices. Accordingly, whenever there is an unnecessary price rise declared by firms and traders, the *muhtasib* uses his authority to prevent it. The crucial point is to preserve freedom in the market while at the same time eliminating monopolistic practices. The Islāmic market economy relies upon the market mechanism to a very great extent. Although the seller should not be forced to give up profit, by the same reasoning he should not be allowed to hurt others. A seller is required to conduct injury-free economic activities so that his economic conduct can be considered Islāmically permissible, i.e. *gharar*-free⁶

The involvement of government in the market is not occasional or temporary. The Islāmic economic system views government as co-existing with other economic units in the market on a permanent and stable basis. Since, however, Islāmic economics does not believe in the 'invisible hands' of the market, the government has to take the role of planning and organizing.

Fourthly, although the Islāmic economy is a free one, its freedom is expressed more in co-operation than in competition. Indeed, co-operation is a general theme of the social organization of Islām which marries individuals' objectives with the social requirements. Islāmic teaching in general, and the verses of the *Qur'an* in particular, emphasize repeatedly the significance of co-operation and collective work.

Fifthly, and finally, the Islāmic system is not morally neutral with regard to resource allocation. Resources must be allocated according to the priorities and needs of the society, and income gaps between classes should be narrowed to attain a desirable allocation of limited resources.

⁶ *Gharar* is lexically defined as the misrepresentation and the misrepresentation of the contract. *Gharar* contract is defined as the one wherein the duties and/or the obligations of one (or more) of the parties involved are uncertain while others' duties and obligations are relatively immuned from such uncertainty and the parties involved in the contract should be mutually agreed provided that the parties have equal power when the contract is determined.

To conclude, although the market system is recognized by Islām, because of the freedom it offers to individuals, it is not sacrosanct, it is the goals of Muslim society which are more important. The market system is only one of the means of attaining these goals, and as such must be modified as necessary.

In Islām, property rights are not only qualified and limited, but are also tied to certain obligations towards others. An individual is obliged to share the responsibility of the poor. Islām regards wealth as a source of subsistence for all people irrespective of its distribution and formal ownership. Hence the Islāmic economic system includes the payment of *Zakāt*, which is one of the highest religious duties of Muslims.

2.1.3 Islāmic Taxation Through *Zakāt*

Zakāt is a tax of 2.5% on net wealth and 5% on agricultural products in the case of artificial irrigation and 10% in the case of natural irrigation, (Volker, N., undated paper on the Islāmic View). It covers almost every kind of wealth: cash and bullion, stocks and inventories, agricultural produce, cattle, mineral wealth etc. Once fixed, exception limits and rates of *Zakāt* apply for ever.

As a permanent provision in Islāmic law, this redistributive measure is necessitated by the unequal distribution of abilities which in turn causes unequal opportunities. This measure is supplemented by the Islāmic law of inheritance, which limits the right of ownership in time by the life of the owner⁷. Thus, the inheritance law of the *Qur'an* gives details concerning the distribution of the estate because a human-being is only a vicegerent on earth and has no absolute rights.

Zakāt is not a charity. It is the right of the have-nots to a proportion of the wealth of the haves. The *Qur'an* asserts

'And in whose wealth there is a right acknowledged for the beggar and the destitute', (Suret Ma'āriq or the Ways of Ascent, verses 24-5).

It is entirely different from taxes levied to meet the cost of government. *Zakāt* is a measure designed to transfer part of the wealth of the rich to the poor so that the latter are guaranteed an acceptable standard of living. Jurists almost agree

⁷ After death, an owner of wealth does not have any right to it.

unanimously that the duty of the whole Muslim society in general and of its rich in particular, is to take care of the needs of the poor. If the well-to-do fail to fulfil this responsibility, the state can and should compel them to assume their responsibility.

In general, Islām holds that an individual should be guaranteed the minimum standard of living determined by the degree of development and other attendant factors. The distribution measures specified by Islām are likely to reduce concentration of wealth and sharp inequalities in three ways:

Firstly, through the Islāmic law of inheritance, which distributes the property among a number of heirs,

Secondly, through the principle of *Zakāt*, which takes from the rich and gives the poor.

Thirdly, through the provision of surplus consumables.

The government's guarantee of a minimum standard of living stems from its role as an agent of the public; it is authorized to collect enough funds through *Zakāt* and other sources to finance this guaranteed level. However, what has been stated above is an ideal picture of the role of *Zakāt* as a source of finance and as a redistributive instrument. Practically this may not be the case; the achievement of this depends on whether or not *Zakāt* principles are applied effectively. Certain difficulties prevent the effective use of *Zakāt* as a source of finance and as a built-in-stabilizing tool. Among these are assessment and utilization problems. A process of classification is needed to determine which types of property are subject to *Zakāt* payment so that the financial authorities can estimate revenue in quantitative terms. It is equally important, however, to determine whether the *Zakāt* funds may be paid only to those listed conclusively in the *Qur'an*, or whether they may bypass those recipients eligible and be used to finance the supply of public goods, which would then reach those groups of eligible recipients indirectly.⁸

⁸ For detailed discussion of the economic implications of *Zakāt*, see Shumo, E. Ahmed (1990), *The Theory Of Zakat And Its Applications In The Sudan*, Ph. D. Thesis, Department of Economics, University of Durham.

The distributive issue is a general theme of Islāmic economics. Most important is the question of usury, or interest rates. In fact, although Islāmic economics embraces many different aspects, the theory of interest is central to this particular type of economic thought. In order to provide strong evidence for the strict prohibition of interest rate by the jurists and theologians, the following sections include a comparative study of the viewpoints of both the classical philosophy and orthodox Christianity on the issue of usury. Both condemned the practice of usury. A discussion of these viewpoints precedes a preview of the position of the Islāmic *Shari'a* on the issue.

2.2 Usury from the Philosophical & Christian Viewpoint

In the Christian religion, usury was originally prohibited. Religious authorities continued to defend the prohibition until the sixteenth century when ideas on the illegality of usury differed and the growth of business forced religious scholars to change their view-point. The religious opinion on usury is explored here in order to highlight the gradual relaxation of the ban on usury, and how the issue was eventually resolved. The concept of usury in classical philosophy is examined, since the classical viewpoint had some influence on the medieval Christian opinions on the issue. It is important to consider first how lending and borrowing were carried out in the middle ages up to the sixteenth century, at which time a significant change in the process of lending came out.

2.2.1 The practice of usury

That lending and borrowing exists on a large scale in Europe in the Middle Ages can be seen from the whole mass of secular and Christian church legislation on the subject of usury. By the thirteenth century certain main types of transaction were treated as the common norm. At that time, the authors of practical handbooks for administrators pointed out various ways of disguising usurious contracts such as time bargains, fictitious partnerships, excessive security and the exaction of interest in kind or in personal labour; all these forms were practiced latter in the sixteenth century, (Wilson, T., 1925,).

The present institution of the interest rate was developed in the sixteenth century, a time when the role of the financier was expanding and the importance

of commercial capital was on the increase. This increased importance was an inevitable result of the transfer of the control of industry from the individual producer to the commercial capitalist, which was the most salient result of the industrial revolution of the sixteenth century.

The effect of this movement was to render more acute the problem of maintaining the independence of the craftsman against the financier. The financial independence of the craftsman thus became normal and permanent.

By the end of the sixteenth century, agriculture, industry and foreign trade were largely dependent on credit. In addition, the vast majority of lenders were in rural areas and were called usurers.

Not only in the sixteenth century, but also much earlier, goldsmiths frequently appeared in the money lending transactions. They would provide money against deposit of values, and lend money to finance merchants or needy people.

In England, there were two other groups of tradesmen in the sixteenth century who could be regarded as financiers:

The first group was composed of the various textile traders. Accustomed to trading on borrowed money, the capitalists of the wool trade were prominent in the world of finance and a leading role was ascribed to them in the development of the money market in London.

The second was that of the scriveners, who had originally been expert notaries. The scriveners were interested in the legal and financial business carried out by the brokers. The constant mortgaging of land, and the growing dependence of both land owners and traders on credit transactions involved a great increase in the work of the scriveners. This made the scrivener indispensable and put into his hands considerable sums of money. Towards the end of the century, the scrivener became a specialist in certain branches of finance. He became an adviser who was consulted as to the financial standing of the parties to a bargain. From being an adviser he became a financial middleman. The scrivener was not only concerned with broking; his intimate knowledge of business conditions and his practice in gauging the standing of money lenders and their clients made it inevitable that,

in addition to arranging loans, the scrivener should himself take to lending money, (Wilson, T., 1925,).

It is evident, therefore, that lending was not the domain of goldsmiths only, and that there was a mass of financial business which for centuries had been carried on by money-lenders of the other kinds. The importance of goldsmiths in the evolution of banking in England, especially after the Restoration, is not in question; the point is that their role in this evolution was shared by different sources of finance.

However, in England the significant factor in the sixteenth century was not the advance in banking technique, but the discovery by considerable sections of the rich classes that money-lending was as profitable as agriculture, industry and commerce. Usury offered excessive gain and freedom from all kinds of common charge with ease, security and command over those in debt.

This was, in short, the situation of lending and borrowing, in Europe in general and in England in particular, during the Middle Ages and in the sixteenth century. Usurious dealings were practised extensively although social reformers and moralists militated against it and tried to enable the borrowers to maintain their independence by borrowing on easy terms. The issue of usury was a controversial one and was discussed continuously, especially after the Reformation and the development of business affairs.

2.2.2 Usury in the philosophical thought

In classical times, outright opposition to usury came from the philosophers and moralists. The Roman philosophers were unanimous in their opposition on moral grounds. However, two classical philosophers had a significant influence on the issue of usury: Aristotle, a Greek, and Seneca, a Roman.

Seneca considered usury to be morally wrong because it involved paying for time.

Aristotle distinguished between wealth of two kinds: natural wealth, to him an organic concept – which is the result of human effort combined with raw materials; and unnatural finance, brought about by the introduction of the currency system to effect exchange. Finance was seen by Aristotle as an evil art, the most evil form

of which was usury. This was because coin, an inorganic object, whose only proper function was that of a medium of exchange, cannot breed coin and was therefore barren. Thus, according to Aristotle, usury is the result of the unnatural use of money and is contrary to natural law. The basis of Aristotle's position is that money is sterile and cannot bear, and indeed ought not to bear, interest (Taylor, T. W. & Evans, J. W., 1987). Aristotle also dealt with the concept of economic duress and the concept of just equivalence.

The opinions of these two philosophers had a considerable impact on medieval thought, which was an intellectual reconciliation of philosophy (mainly Greek) with the Christian faith. Seneca's opinion became a vital element in the analysis of prohibition, but the impact of Aristotle's ideas was much greater. It was on these foundations that the medieval ban of usury depended.

2.2.3 The Christian opinion: the gradual recognition of usury

In most parts of Europe, the great expansion of the sphere of credit operations which took place in the sixteenth century created a controversy. At the start of the century, to live by usury was seen as immoral or illegal; at the end of the century, money lending was on its way to enjoying the legal security of a recognized and reputable profession. This change was part of a larger revolution which led to naturalistic thinking in the place of theology.

The sixteenth century inherited two main legacies from the Middle Ages (AD 1100-1500). The first was the belief that the world of economic conduct did not form its own laws but was amenable, like other fields, to moral criteria, the ultimate sanction of which was the authority of the Christian church. The second legacy was the body of legal principles with regard to money lending and credit, the most elaborate expression of which was the canon law. The canon law, in the form that reached the sixteenth century, banned payment of the interest rate merely for the use of money, although it sanctioned transactions that were not seen as conflicting directly with the principle of banning.

The view in the Middle Age was that investment in rent charges had always been regarded as unobjectionable, since the payment received by the capitalist came from the bounty of nature and was not wrung from the necessities of man.

The commercial partnership, *commenda*, in which a sleeping partner invested capital with a merchant to 'gain and to lose', was seen as legitimate, since if he shared the profit of the enterprise he also shared the risk. Annuities were not banned for the same reason, i.e. that gain is not certain but contingent.

The medieval writers maintained that it is reasonable that the borrower who fails to pay his creditor at the appointed date should submit to a penalty and that the creditor who loses an opportunity of gain by lending out his money should receive compensation. They showed little objection to the offer of interest as a voluntary gift – although they regarded it as a dangerous exception, (Wilson, T. 1925).

That which remained unlawful until the end of Middle Ages was any payment for a loan where there is no risk, no loss, no inconvenience and no loss of opportunity. In term of economic theory, what was banned is

'net or economic interest', all the other elements of gross interest are 'permissible in the appropriate circumstances', (Taylor, T. W. & Evans, J. W., 1987, p.19). In other words, what was prohibited was what the Mediavel writers called the 'the sale of time itself', i.e., interest as a fixed payment stipulated in advance for a loan of money or wares without risk to the lender. This is, however, a proper interpretation of usury, i.e. when gain is sought from the use of a thing not in itself productive (such as a machine) without labour, expense or risk on the part of the lender.

To the medieval writers, the essence of usury was that it was certain, and that whether the borrower gained or lost, the usurer would take his money. These writers, although sanctioning profits provided that they were reasonable, continued to denounce as immoral the whole range of transactions that ran at variance with the doctrine that an equitable bargain was one from which both parties derived equal advantage. To state it in Islāmic terms, they denounced the *gharar* bargain. (see the preceding section).

The important point here is that religious opinion after the Reformation in the sixteenth century continued to hold that buying and selling, lending and borrowing are to be regulated by a moral law of which the church is the guardian. That is to say, religious opinion continued to condemn usury as contrary to the law of God. But Post-Reformation religious opinion tried to accommodate a classification of

the types of transactions to which the term usury might be held to apply and therefore its denunciation of usury was less rigorous.

Religious opinion after the Reformation maintained that the insistence on the application of moral criteria to matters of business had always been compatible with considerable differences of opinion as to what precisely those criteria were. Sixteenth century writers were of the opinion that the medieval condemnation of usury had been neither unanimous nor indiscriminating. Moreover, they argued that the canon law had gone a long way towards sanctioning transactions involving what was, in effect, payment for the use of capital.

Following this line of argument, the Post-Reformation religious opinion began to recognize certain usurious transactions. However, with the expansion of new types of capitalist enterprise and the drawing apart of different churches after the Reformation, religious opinion began to argue that although almost every one agreed that usury was prohibited, the question was whether usury was to be defined so as to include all interests, or whether, in certain circumstances, moderate interest was to be allowed.

The stricter school defended on the letter of Scripture and the law of the church, regarding usury as differing not merely in degree, but in kind, from payments which, like profits and rent, were morally unobjectionable provided they were not excessive in amount. Usury was to be interpreted as equivalent to whatever is taken for a loan above the principal.

Liberal opinion, concerned to marry Christian teaching to contemporary economic practices, admitted that although the exaction of interest might be reprehensible, its legitimacy depended on the circumstances of the parties involved and the purposes of the loan. Thus usury, instead of meaning the payment of any interest whatever, would mean the payment of interest which, in the circumstances of the case, was extortionate.

From the middle of the century conservative influence was undermined not only by attacks from the world of business, but also by differences among the religious authorities themselves. Their response to the whole issue was confused.

Aristotle's thesis which holds that 'money does not breed money' was challenged: since in practice, land and capital are interchangeable investments, why permit one but condemn the other? In this view, all extortion is to be avoided, but lending at interest, provided that the rate is reasonable and that loans are made freely to the poor, was not regarded as more exorbitant than any other of the economic transactions without which human affairs could not be carried out.

Once stated, this became the position of most powerful religious movement. The consequence of this was an economic system arranging for gratis or concessionary loans for the poor, while the commercial world was left free to engage in whatever transactions it saw suitable. The whole body of opposition to usury was weakened. Luther, while not rejecting prohibition outrightly, accepted interest as a concession to human weakness. The growing capitalists were provided with the moral justification required to recognize their economic practices.

After the middle of the sixteenth century, the whole body of legal doctrine which had hitherto condemned the capitalists was reversed. In one country after another, the rapidly growing financial interests revolted against the system which penalized the most profitable payments of their capital.

The laws against usury were criticized not in detail but in principle. The religious revolution of the sixteenth century brought the canon law under review. The Aristotle basis of the whole concept was challenged. Writings of the Post-Reformation thinkers had the effect of removing anti-usury laws from the statute-books of Western European countries by the 1860s.

The question was no longer whether interest was right or wrong, but whether the rate of interest legally sanctioned was reasonable or excessive. Hence the interest rate as such was no longer considered sinful; indeed, it was deemed necessary for the success of trade.

However, the absence of the anti-usury laws raised the questions of economic duress and injustice once more, and by the end of the nineteenth century new anti-usury laws were reintroduced.

One important point is that although usury had been recognized in one way or another, what was never accepted was the argument that interest was justifiable

because lending bridged the time gap. The theological argument was that time is common to all, and thus one should not charge for the passage of time.

To that end, one notices that usury was originally prohibited in classical philosophies and the Pre-Reformation theologian thought. With the increasing domination of commercial capital and the expansion of credit transactions and business life, payment of interest was recognized gradually, and in the latter stage of industrial development was regarded as necessary.

In fact, the prohibition of usury was not peculiar to the secular or Christian writings in the Medieval ages. Usury was condemned by Jews in the old Testament. The Greek and Roman laws, while not prohibiting usury altogether, regulated it. More crucial is the ban imposed on usury by the Islāmic *Shari'a*. This is important both for the sake of comparison and for the purpose of this study, which aims at pinpointing an appropriate alternative for the contemporary interest rate-based financial system. The *Shari'a* opinion on the subject of usury is explained below.

2.3 Usury in the Islāmic *Shari'a*

Linguistically, *ribā* means increase. The word is derived from the Arabic word *rabā*, i.e. to grow or increase. *Rabā* means increase. That is it means literally to grow or inflate or increase or excess. At the root of it is the increase of usury of money where it has increased. The word is applied in the sense of an additional increase in an object over and above its original size or amount (Wilson, R. J. A. 1985, p.24). As a technical term, it means usury and interest, and in general any unjustifiable increase of capital for which no compensation is given.

In the Pre-Islāmic era, *ribā* signified the increase of money in consideration for an extension of the term of maturity of a loan. The Pre-Islāmic Arabs used to pay the money on loans and received a certain sum leaving the principal sum untouched. When the maturity date expired, they would claim the principal sum from the debtor; if it was not possible for the debtor to repay, they would increase the principal sum and extend the term. Thus there were transactions with a fixed time limit and payment of interest, as well as speculations of all kinds that formed an essential element in the trading system of the pre-Islāmic era. A debtor who could not repay the capital (money or goods) with the accumulated interest at the

time it fell due was given an extension of time during which to pay, but at the same time the sum due was doubled. This is referred to clearly in the *Qur'an*.

2.3.1 Qur'anic injunctions concerning ribā

In the Holy *Qur'an*, the first verse which deals with *ribā*⁹ is in *Suret Ar Rum*:

'That which ye lay out for increase through the property of (other) people, will have no increase with God: But that which ye lay out for charity, seeking the countenance (face) of God will increase: It is these who will get a recompense multiplied', (Suret Ar Rum (Romans), verse 39.)

According to the *Qur'anic* exegetes, this verse was revealed in Mecca before the emigration (*Hijra*) to Madina, i.e. before the prohibition of *ribā* for which the verse paved the way.

The second verse which mentions *ribā*

'For the iniquity of the Jews we made unlawful for them certain (food) goods and wholesome things which had been lawful for them; in that they hindered many from God's way. That they took usury, though they were forbidden, and that they devoured Men's substance wrongfully; we have prepared for those among them who reject faith agrievous punishment', (Suret An Nisā', (Women) verses 160-161.)

An express prohibition follows in *Sura III* which mentions *ribā* and bans it for the first time,

'Oh ye who believe! Devour not usury, doubled and multiplied; But fear God; that ye may (really) prosper', (Suret Al Imrañ (family of Al Imrñ), verse 139.)

This is the first verse to impose a ban on usury. In interpreting this verse, the exegetes agreed that the expression **multiples** does not restrict the ban but expresses usury which people were accustomed to practice, assuming that this matter of **multiples of multiples** is no more than a description of a state of affairs and not a condition relevant to the imposition (Qutob, S., 1971).

The prohibition was intensified in *Sura II*. The verses in question, the last to be revealed concerning the prohibition of *ribā* are as follows:

⁹ *Ribā* is taken throughout this study as synonymous with interest or usury.

'Those who devour usury will not stand except as stands one whom the Evil (satan) One by his touch hath driven to madness. That is because they said: trade is like usury; But God hath permitted trade, and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past, their case is for God (to judge); but those who repeat (the offence) are companions of the fire: they will abide therein (for ever). God will deprive usury of all blessing, but will give increase for deeds of charity: for he loveth not creatures ungrateful and wicked. Those who believe, and do deeds of righteousness and establish regular prayers and regular charity, will have their rewards with their Lord: On them shall be no fear, nor shall they grieve. Ye who believe! Fear God and give up what remains of your demand for usury, if you are indeed believers. If ye do it not, take notice of war, from God and his Apostle: but if ye turn back, ye shall have your capital sum; deal not unjustly, and ye shall not be dealt with unjustly', (Suret al Baqara, or the Cow, verses 277-279).

In these verses *ribā* is condemned and prohibited in the strongest possible terms while legitimate trade or industry increases the prosperity and stability of individuals and nations, dependence on usury would merely encourage unproductive activities. The *Qur'an* also speaks (in verse 280 of the same *Suret*) about further concessions on behalf of debtors. Creditors are asked to: (a) give up even for claims arising out of the past on account of usury, (b) to give time for payment of capital if a debtor is in financial difficulties or, (c), to write off the debt altogether as an act of charity.

Thus the verses mentioning *ribā* show that all unlawful grasping of wealth at the expense of others is condemned, and many different practices¹⁰ either by individuals or nations are covered by this ban. The principle is that any profit that a human-being seeks should be through his own exertions and not through the exploitation of others. The *Qur'an* regards *ribā* as a practice of unbelievers, it demands, as a test of belief, that it should be abandoned.

Dealing with usury as mentioned in the *Qur'an* applies to debts and is not related to sales. Usury in sales is not subject to the stipulations of the *Qur'anic* verses. However, although usury is a general term, it is intended to give a specific

¹⁰ Some scholars define *ribā* as any increase sought through illegal means, such as usury, bribery, profiteering, fraudulent trading etc. See Yousif, A. A., *THE Holy Quor'an: Text, Translation and Commentary*, second ed., 1984, p. 1062.

meaning, which is not restricted to a certain form of usury of the Pre-Islāmic era, which involves doubling and multiplicity of debt.

2.3.2 The Prophet's sayings on *ribā*

The Prophet's authenticated sayings (*hadīths*) that deal with the subject are numerous, so it will be sufficient to mention only some of them. The usury considered by the *Qur'an* is called 'debt usury' (or *nasi'a*, *naḥira* and *dain*) whereas the *Sunna* explains 'sale usury'. In practice, the *Sunna* discusses both types of usury – debt and sales – but its *rôle* in regard to the first kind is one of enforcement of the God's commandment and assertion of what is banned. What was generally understood in the earliest period from the *ribā* forbidden in the *Qur'an* seems only to have been interest on loans; any thing that goes beyond this is to be regarded as a later development.

The first time the prophet dealt with debt usury was when one tribe (the Thaqeef) claimed repayment of its debt from another tribe (the Bani Muqeera), a debt which remained from the Pre-Islāmic usury. The Prophet told th Thaqeef that the *Qur'an* had ordered the abandonment of the remnants of Pre-Islāmic usury. The second time the Prophet dealt with the subject was when he spoke in his last sermon (on the occasion of the farewell pilgrimage),

'Every usury is disparaged, and the first usury I disparage is our's- Abbas Bin Abd Al Muttalib's usury- that is the prophet's relatives' usury. It is all disparaged', (As Sālūs, A. A., 1987). Thus the *Sunna* ascertained the prohibition of debt usury as that against which the *Qur'an* gave judgement.

As mentioned above, the *Sunna* confirms the prohibition of debt usury and prescribes and bans sales usury. The view on sales usury is laid down in a group of traditions. There is a considerable number of *hadīths*, but the most famous and accepted one is that:

*'Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, the like for the like, hand to hand (yad^anbi – yad, i.e. immediate sale), (But) if the kinds differ, then sell as you may like if from hand to hand'*¹¹.

¹¹ Related by Ahmed, Bukhari, Muslim and others (these are Muslim jurists.)

Another *hadīth* is one narrated by Abu Sa'īd from the Prophet who said:

'Do not sell gold for gold unless an equivalent for an equivalent, do not prefer one and not the other (i.e., no discrimination between equivalents), do not sell what is available now for what is not available at the place of sale'

The *fukahā'*¹² (Muslim jurists) interpreted these sayings as positing two types of sales usury:

(i) Increase Usury (*ribā al- fadl*)

This occurs when (a) there is a sale where items of the same kind are exchanged; (b) where both items are of the kind capable of *ribā* (*māl ribawi*); and (c) where there is an increase in either item over the other even if they differ in quality.

Therefore, when items of the same type are exchanged in sale, if either of them carries an increase over the other, the increase is *ribā*, provided both kinds are property items subject to usury (*māl ribawi*)

(ii) Delayed Payment Usury (*ribā an Nasī'a*)

This form of sales usury occurs if, (a) there is a sale; (b) if both items are properties subject to usury (*māl ribawi*); and (c) if one of the items is received at the time and place of the sale and not the other item.

Therefore, delayed payment usury occurs when an item, available at the place of sale, is sold for an item which is not available at the place of sale, even if the two items are exchanged for equal quantity in order to avoid increase usury. Equality in exchange of both items is not a condition here, owing to their dissimilarity.

However, an overview of the jurists' view-points on the matter will certainly reveal that there are divergences in interpretation of the *Qur'anic* verses and the Prophet's *hadiths* concerning *ribā*. The important point is, firstly that these considerable differences are a normal phenomenon in Islāmic jurisprudence and are differences on details, not the fundamentals of jurisprudence; and secondly, and much more importantly, in spite of these differences, the opinion of the majority

¹² *fukahā'* (singular is *faqīh*), *'ulamā'* (singular is *'ālim*) are Arabic-derived terms used interchangeably for Muslim jurists or scholars.

of Muslim jurists is by no means likely to justify debt usury or sales usury. The 'fukahā' are unanimous in their condemnation of *ribā* and are backed by both the *Qur'an* and the *Sunna*, the main sources of the Islāmic *Shari'a*. Strong support for the complete agreement on the ban on usury is, practically and unequivocally, provided by what has been stated by the second conference of Islāmic Researches Academy in 1965. In that conference the 'ulamā' issued a *fatwa* (legal ruling) that interest on all kinds of loans is prohibited absolutely, without any differentiation between consumption or productive loans, (see above).

2.4 The Medieval Christian & Islāmic Opinions

2.4.1 Summary

What can be deduced from the Pre-Reformation Christian and Islāmic positions on usury is that both prohibit usury outright; all that is clearly permissible is a return from a partnership, *Commenda*, provided the partner making the investment genuinely shares the risk. That is, both call for a share of risk between the lender and the borrower, and no single party is allowed to acquire extra advantages at the expense of the other partner. Both reject time as a justification for the payment of interest and say that when gain is sought from an activity which is not in itself productive without labour, expense or risk on the part of lender, it is illegitimate and reprehensible. According to both, the essence of usury is that it is certain and whether the borrower gains or loses, the lender always takes his pound of flesh. They call therefore for an equitable bargain from which both parties might derive equal advantage according to the amount of risk they run.

However, in spite of the fact that the positions of the two religions are almost identical, there is a slight difference regarding the matter of usury.

Classical Christian thought maintains that the borrower who fails to pay his creditor at the appointed date should submit to a penalty, and that the creditor who loses an opportunity of gain by standing out of his money should receive compensation. The Islāmic opinion is that the borrower is not liable for punishment if he fails to pay up on the maturity date. Islām suggests that the lender postpones the date of payment without taking interest from the borrower or, preferably, cancel the whole amount of debt as *gratis*. In fact Islām is very emphatic on this point,

to the extent that the *Qur'an* mentions this call for cancellation of the debt if the debtor is in financial difficulties immediately after the verses that prohibits *ribā*:

'If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it, by way of charity, that is best for you if ye only know', (Suret Al-Baqara, verse 280).

Another slight difference is that medieval Christianity allows the offer of interest as a voluntary gift, even though it was regarded by religious men as a dangerous exception. Islām does not allow even the voluntary interest rate as a gift to the lender.

However, Post-Reformation Christian thought is very different from the Islāmic thought, as this has removed itself from its own origin – hence the gap between contemporary Western thought and the Islāmic stance (Taylor, T. W., & Evans, J. W., 1987). The difference has originated from the side of the former, which tried to accommodate classifications into types of transactions in which the word usury might be held to apply, and to find way of recognising moderate interest by saying that not all interest is to be generally condemned.

This does not mean that the modern Western economic system does not call for ethics and morals in the course of economic transactions. It is by all means an ethical system; but with the passage of time ethics have become implicit rather than explicit, as they were in the medieval economic system.

This built-in ethical characteristic, which has unfortunately become only implicit, is obvious in the recent developments that call for an ethical character to the economic system. Moreover, there is a growing criticism that contemporary economics is becoming less able to offer satisfactory remedies to problems such as the international debt crisis. In 1987 one of the Vatican Commissions advised Third World debtors that they are not always *morally* obliged to repay their creditors and that debt defaults can be justified (Taylor, T. W. & Evans, J. W., 1987).

In fact, these calls for the re-orientation of contemporary economics to take into account the ethical considerations and to share the risk with the borrower are in complete harmony with the arguments and fundamentals of Islāmic economics which is known as the profit-and-loss sharing system.

The discussion on usury has thus far centered on a comparison between the stance of Christianity and the Islāmic opinion. There is, however, much literature on the issue in economic theory. The next chapter discusses the issue of interest rate and profit in economics, examining specifically the development of the interest and profit theories and their similarities and differences with the Islāmic view-point.

Chapter III

Interest Rate And Profit In Economic Theory

3.1 Interest Rate Theories

Interest in its primary meaning is the payment for the use of money. The word came into use in the late Middle Ages, replacing the term usury. Interest in the modern sense was in the Middle Ages only merely an important type of usury; since then the term usury has become specialised to mean interest at exorbitant or illegal rates. In tribal and economically underdeveloped societies there is a strong sentiment against lending money at interest, which is usually prohibited as between members of the social groups, (Knight, Frank H., 1934). In Greece and Rome, the opposition to money lending was grounded in the idea of social respectability.

However, as mentioned in the preceding chapter, in the Middle Ages the prohibition was premised on religious and ethical principles. The doctrine basis of the opposition to interest was found in the concept of objective value, for it was argued that no value could attach to the use of consumptible good separate from the good itself, and money was regarded as consumptible. Another argument was directed against the payment for time, over which no one could claim ownership.

But as trade and industry developed and a general loan market came into being, lending ceased to be treated as different from other market transactions. During the sixteenth century there developed a movement to abolish the prohibition, so that the first legal action was in England; the prohibition of usury was replaced by a legal maximum.

In the two following centuries, the justice of charging interest was still a controversial subject in the theological and political writings, but no attempt was made to discuss interest as an economic problem. The attack ran in the old moral and religious terms, and the defense was based on the fact that the use of money is a source of gain and is of value to both the debtor and the creditor and hence should be treated by law like other articles of commerce. Latter, the demand for

regulation was based on merchantilist grounds so that English writers, for instance, argued that low interest was necessary to help English business to compete with foreigners in the export trade, (Encyclopaedia of the Social Sciences, 1934, p. 132).

3.1.1 The Classical School

However, the next stage in the historical development of interest theory comprising the work of the classical school of economists which extends for more than a century after the publication of Adam Smith's work 'Wealth of Nation' in 1776.

Writers of this school were regarded as contributing little towards the formulation of an integrated distribution theory in which interest rate falls. This criticism is sound because: first, classical writers regarded the problem of distribution not as one of pricing services furnished to production, but as one of dividing the total income of society into the shares of the three economic classes which they recognised. The landlord's share, rent, was explained as a 'surplus' on the ground that it did not enter into the price of the final product stated in terms of pain cost; second, wages were explained by the simple observation that the labour must live; third, the share of the capitalist, which was called profit, was regarded as a residue after the other shares were paid. J. S. Mill, for instance, thought that profit arises because labour produces more than is required to sustain the labourer; fourth, the classical school never faced the problem of the nature of capital as a quantity, their general conception of capital was that like products generally, it is produced by labour and hence is legally the embodiment either of a certain quantity of labour or of the subsistence goods on which the labourers live while performing that labour; they, therefore,

'could not have said any thing very illuminating about the rate of interest', (Knight, Frank H., 1934, p. 132).

In fact though the classicals show shallow argument regarding interest, they showed profound insight in many partial analyses. For instance N. W. Senior, following up hints in Ricardo, developed good ideas in connection with capital and its return. In his effort to support the pain cost theory of price, he argued that the essence of capital as an element in cost is the pain of abstinence. But although Senior repeatedly explained the productivity of capital, he stated clearly

that abstinence has nothing to do with the return after capital has changed hands through gifts or inheritance.

Economists of the classical school achieved progress also in analysing the various elements of the gross return and Adam Smith himself made it clear that in typical cases part of the return must be treated as essentially a wage and another part as compensation for risk, true interest being different from both. On the other hand, J. S. Mill further differentiated between payment for risk as an insurance premium against a recognised hazard, and payment for mere accidental deviations from a normal return because of miscalculation on unforeseen changes. However, these beginnings developed into the tendency to treat profit not as the gross income including interest, which was the usage of the classical writers, but as the final residual income of the entrepreneur after a deduction of both interest and wages of management.

3.1.2 Exploitation Theories and interest

The socialistic schools were considered developed in part as a result of the confusion in the classical reasoning between the causality problem of the market value of services of various kinds and the ethical question of remuneration for sacrifice. These schools treated all property income as exploitation of labour. The different socialist writers, Gadwin, Thompson, Louis Blane, Robertus and Karl Marx, all held the view that slavery feudalism were merely replaced by the economic power of property ownership based on economic freedom. They considered labour as the producer of all wealth, the belief that was already held by the classical school.

Exploitation theories attacked the classical schools on ethical ground regarding abstinence as a satisfaction for interest. The former held the view that most of the abstaining seems to be done by persons who have first consumed all they can or at least more than they need. Knight criticised the exploitation theories on this point by saying that the ethical challenge by these theories goes without saying that in competitive society every income is based on economic power, and whether or how far property income is defensible on grounds of abstract right or of social expediency is the question to be answered by the ethical or political philosopher rather than by the economist. Knight thought that interest is merely a form of payment for the use of real wealth transferred from one person to another, he

regarded its merits or demerits as those of private property and of social order based on ownership. He further criticised the exploitation theories saying that it is questionable whether a clear-cut distinction can be drawn between property and labour income, and he agreed with the classical view stated by Smith and Senior that a large part of the earning power of individuals paid for as labour is really the fruit of an investment not different in principle from any other, (Knight, Frank H., 1934).

3.1.3 Time Preference Theory and interest

Interest has been justified according to this theory via the existence of positive time preference that emerged from the difference between present and future valuations. Present goods worth more than future goods of the same kind and number. Böhm Bawerk attributed this to three reasons. First, individuals are less capable of forecasting the future. Second, the different circumstance of want and provision in the present and the future. Third, present goods possess an economic superiority over future goods because they make it possible for more goods to exist in the future. In other words, present goods worth more than future goods because capital is productive, (Böhm Bawerk, 1891). However, according to Böhm Bawerk, the first two reasons alone explain the existence of a positive interest.

Fisher as well argued that people prefer earlier income enjoyments to deferred ones basically because future income is uncertain. This uncertainty of future income affects the psychological time preference of the income earners, encourage them to prefer present consumption, (Fisher, Irving, 1965).

Thus, for the time preference theory interest rate is paid to encourage saving. It is a reward for individuals' patience to choose future rather than present consumption.

3.1.4 The Productivity Theory and interest

The English economist Jevons had given a mathematical version of a type of productivity theory and discussed the relative valuation of present and future goods. But this work received limited recognition until similar views were presented in a more popular form by the Austrian school whose thinkers were Weiser and

Böhm Bawerk. However, Böhm Bawerk's work is connected with the interest theory and on which discussion was concentrated in the period preceding the World War.

Although, however, Böhm Bawerk's view rests on the preference for the present as against future goods, it is in reality a productivity theory because he put the possibility of the productive investment as is the most important reason for such a preference. Jevons, Böhm Bawerk and the writers who have followed their line of approach interpret capital as meaning essentially the substitution of more indirect or roundabout for more direct methods in production, as an increase in the time length of the production process with a resulting increase in efficiency of the use of primary factors.

According to this theory, there is a productive good on which a value is set. This value is of course the value of the stream of income which it is expected to yield in the future in comparison with similar units of services or satisfaction at the moment. This future income is discounted by the prevailing interest rate. So the interest rate is the discount rate. But this discount rate is possible only under perfect competition and in actual markets economic adjustments work imperfectly. If so, then the yield of productive good can not be predicted exactly at the time when productive commitments are made, and therefore productive property from the start may yield more or less than the interest on its cost, (Metzler, 1950).

However, the longer the production period the more uncertain becomes the relation between return and cost. Thus, it is unacceptable to determine in advance an interest rate for either savers or borrowers as long as unforeseen changes occur and the owner of productive wealth affected by these changes will receive a speculative profit or suffer a speculative loss. It is on this ground of uncertain result of productive commitments that the Islāmic financial theory rejects interest rate to be given in advance.

3.1.5 The General (eclectic) Theory of interest

This can be called the combined theory of interest. It unifies the time preference and productivity theories in a supply-demand analytical framework. Here, interest can be paid because capital is productive and must be paid because people

suffer a disutility in saving. An individual saver will give up present consumption only if he is compensated by a constant stream of future income approximately equals to the rate of the time preference. Likewise, a borrower expects a stream of net return and will not continue borrowing unless the marginal productivity of capital – the rate that equalizes the present value of the expected net returns with the cost of investment – is greater than or at least equal to the rate of interest demanded by the lender. Hence, the equilibrium rate of interest equates the marginal time preference with the marginal productivity of capital.

Generally, eclectic theory considers the problem of interest in terms of supply and demand. The supply of the commodity, i.e. the use of capital comes from savings while the demand for it comes from the investors. The supply and demand reveal respectively time preference and productivity. According to this theory interest is a price. The interest rate is simply determined by the willingness or the reluctance of persons to save and the expected productivity of capital that could be secured by this saving.

However, this theory could be criticised on the ground that it is only through the expectation of returns that this theory might justify interest. The overall rate of interest reflects the average of the individual investors' expected 'average' rate of return. But the overall expected rate of interest is not necessarily equal to the overall actual rate of interest or the investors' 'average' rate of return, (Abbas, A. B. M., 1987).

3.1.6 The Dynamic Theory

The dynamic theory was initiated by Schumpeter whose theoretical construction regards interest as belonging essentially to dynamic economy. For Schumpeter, interest is the payment for the use of money purchasing power that enables entrepreneurs to acquire capital goods which are capable of generating profit, and, hence, interest is a derivative of profit.

In competitive equilibrium, profit is likely to be zero and may arise only due to monopolistic practices. So the question arises, how can interest be a derivative of profit though the latter might disappear in equilibrium situations. Schumpeter answered this question by the concept of innovation. Continuous innovation causes

continuous disequilibrium and continuous demand for capital and hence gives rise to profit. Interest is, therefore, a phenomenon of economic dynamics.

The dynamic theory could be criticised on the ground that it regards interest as a reward for money, i.e. reward for the purchasing power of money. But if interest is a derivative of profit and if profit is uncertain how could interest be fixed in advance although its source (profit) is uncertain?

3.1.7 Keynes' (Liquidity Preference) Theory

In the Keynesian theory, holding cash or interest-bearing assets – i.e. savings, depends on income via the marginal propensity to consume. If saving and investment are equal, then it is income and not interest that ensures this equality, (Keynes, J. M., 1937A). Thus in his view-point Keynes regarded interest as a consequence of saving and not its cause.

However, the Keynes's propensity to consume is regarded as another expression of the psychological time preference, (Hazlitt, 1959). Moreover, he did allow for trading off between holding money for transaction and precautionary motives on one hand, and the return for holding earning assets on the other hand. In other words, interest can affect the form of saving and, if this is so, interest might affect the supply of money.

The 'liquidity preference' is the core of Keynes' monetary theory of interest. He regarded interest as the premium obtainable on current cash over deferred cash, (Keynes, J. M., 1937B). He regarded holding of cash as a claim over the productive goods. Thus, according to this theory, interest is a price that should be paid to get use of this claim on the productive asset.

In short, in Keynes' theory, interest is a monetary phenomenon; it emerges from the efficiency of holding money and is therefore determined by the supply and demand for money. The change in the rate of interest depends on the responsiveness of the money supply to the changes in the demand for money.

However, this theory can be criticised as it presupposes an existence of interest whose level is to be determined by monetary factors. But the claim that monetary factors only do affect the interest is insufficient to drop the effect of real factors,

(Hazlitt, 1959). Moreover, even if this theory is accepted as an explanation of interest, it cannot be generalized because if interest is the price for parting with liquidity, a barter economy should accordingly be interest-free, (Abbas, A. B. M., 1987).

3.1.8 The Natural and the Market Rate of Interest Theory

This is a theory distinguishing between the natural and the market rate of interest, as determined respectively by the real and monetary factors. Wicksell argued that the natural rate of interest is that rate which equates savings and investment and the market rate a deviation from the natural rate, (Wicksell, K., 1936). The monetary authorities can affect the market rate of interest by affecting the supply of money; thus the market rate could be kept well below the natural rate of interest.

According to this theory, if the market rate is above the natural rate, borrowing will be discouraged, the volume of money and credit will be contracted and hence there will be a fall in prices, activities and employment. Conversely, if the market rate is below the natural rate of interest, borrowing will be stimulated, and money and credit will be expanded.

It is noticed that this theory just confined itself to the role of the real and monetary factors in affecting the magnitude of both the market and the real rate of interest. Still there is no answer to the question why interest, whether natural or market rate, is fixed in advance?.

3.1.9 The Loanable Funds Theory

This theory combines the real factors of interest determination emphasized by the neo-classical theory with the monetary factors mentioned by the Keynesian theory. The theory is generally based on the proposition that the greater the reward (interest) the greater the volume of purchasing power offered to be used as capital, and the lower the reward the greater the volume of purchasing power demanded by businessmen. In equilibrium, the rate of interest equates the *ex ante* demand for loanable funds, (Cochran, 1983). But the theory still says nothing about why should the loanable funds be priced in advance?

3.1.10 Conclusion

What could be deducted from an exposition of all these theories of interest is that they discuss the problem from different angles, having considered different factors that might affect interest rate. However, all the theories are concerned with the expected rate of interest only. The question of real rate of interest remains untouched. In other words, if both the borrower and the lender of capital, any form of capital, are to get 'fair' gain from any joint work, negotiation on a pre-determined interest rate would be unfair for either of the two parties. If the borrower is successful and gets high returns, the lender would be deprived of being paid less than what he would have to get on a non-pre-determined rate. If, on the other hand, the borrower incurs losses, he still has to pay the fixed rate to his creditor. Thus, both parties should share the 'actual' return of their work not the 'expected' return, the one, i.e. the expected return, which all theories of return try to justify. The economic activity based on actual returns, that is on profit-and-loss, is the one advocated by the Islāmic financial theory.

3.2 Theories of Profit

Modern theories of profit based their views on the subject following the classical economists who were concerned with the problem as one of dividing social income among the socio-economic classes, landlords, labourers and businessmen calling the share of businessmen as profit.

3.2.1 The Classical Theory

The classical economists envisaged the process of division in two stages: they divided, first, total income between rent and gross income of the capitalist; then they divided the latter between the capitalist and the labouring class. They regarded wage as being determined independently, and the remaining part of gross income is a residuum for capitalist. However, the classicals' division was criticised as it failed to implement the process of distribution through any discussion of the actual workings of competitive principles of price fixing.

The classical economists from Adam Smith onward differentiated between interest and profit, but this differentiation was not so clear because at that time

capital was almost employed by its owner. Firms which borrow at interest in modern times were few or not yet developed. They, however, recognised three elements in the income of the capitalist entrepreneurs, first, a payment for the base use of capital, second, payment representing payment for entrepreneur's activities as a manager and, third, payment to compensate the entrepreneurs for risk.

Profit as a unique form of income not reducible to remuneration for either capital or labour was a view developed by German writers. Thünen defined profit as the residue after deduction of all three payments, interest, insurance for risk and wages of management. Von Mangoldt H. made an elaborate analysis of profit, recognising payments for wage and for risk as actual profit, but defining profit as a surplus above all costs.

3.2.2 Exploitation Theory

However, the classical writers included different elements in the concept of profit, and their distinction between land and capital was loose. The socialists, Marx and others, as developing the classical economics, dropped this distinction. They, therefore, merged land with capital and regarded profit as including all non-labour income. Their view of profit is one of labour exploitation.

However, in replying to such type of the argument, some writers like Knight (1934) thought that in the idealised society of equilibrium theory, there would be no occasion for assigning the distinctive name of profit to any type of return. He argued that in the perfectly competitive pricing systems, all services are assumed to be valued correctly and precisely, and under these conditions the entire produce in the form of income would be divided exactly among workers of various sorts and owners of property of various sorts. Thus there would be only two forms of income exist, wage, as a payment for personal services, and rent, as a payment for property services. Interest and rent are differentiated only by the form of equity which the recipients hold.

In actual society economists commonly use the expression 'pure profit' to refer to the income of the business after deduction of wages and rent or interest for all the human and property services employed in the enterprise.

However, attempts to present a theory of profit restricted in meaning have, in the end, taken two main directions: the first centers in the effort to identify a peculiar form of service of which profit is the remuneration, a service which can be rendered only by the owner of an enterprise and cannot be paid for in the form of a wage or a salary. Since the ordinary managerial activities are frequently hired on a salary basis, there left the service of 'risk bearing' as a basis for such theory. The second direction revolves around the view which brought about recognition of the fact that the business manager not merely bears risk but estimates risks and selects those to be borne. Thus, the risk theory tends to revert to an examination of the functions of management and the nature of business ability, a problem which clearly ties up at the same time with the nature of the risks which can not be *insured*. The concept of profit as a remuneration for unique form of rare human qualities has been advanced by Maurice Dobb.

3.2.3 Risk Theory

The doctrine that profit is to be explained exclusively in terms of risk has been rigorously upheld by F. B. Hawley who finds in risk-taking the essential function of the entrepreneur and therefore the basis of his peculiar income, (Hawley, F. B., 1907).

This doctrine is, however, criticised on the point that it fell into the confusion in assuming that the crucial value of the risks taken is known to the entrepreneur. If a risk is known, it will not lead to any reward of special payment at all.

In fact Hawley comes nearer to the crux of the matter in his insistence of the responsibility and risk of proprietorship as the essential attributes of entrepreneurship. The entrepreneur, he said,

'is the owner of all real wealth, and ownership involves risk; the coordinator makes decisions but it is the entrepreneur who accepts the consequence of decisions', (Hawley, F. B., 1907, p. 88). It remains that Hawley treats risk as a known quantity. This view is, however, identical to the Islāmic view-point in one aspect that the capital owner should share risk consequences of the work with the capital user. Precisely it is similar to the *muḍāraba* mode of finance, (see the next chapter).

3.2.4 Dynamic Theory

J. B. Clark developed the main alternative to risk theory, one which connects profits with economic change or economic dynamics, (Clark, J. B., 1900). Walras and Cassel also explained profit as resulting from friction in the working of the competitive system. Moreover, Schumpeter developed theories of profit as due to the dynamic character of society, (see the section above).

3.2.5 The Risk and Dynamic (eclectic) Theory

An important part in the theory of profit is the view combining the conceptions of risk, of economic change and of the role of business ability elaborated by F. H. Knight.

First, the procedure of taking changes in conditions as the explanation and cause of profit is criticised in that it overlooks the fundamental question of the difference between a change that is foreseen a measurable time in advance and one that is unforeseen. If, however, all the dynamic changes are foreknown for a sufficient time before they take place, then the whole argument based on the effect of change will stand invalid. Dynamic changes, as Knight put it,

'give rise to a peculiar form of income only in so far as the changes and their consequences are unpredictable in character', (Knight, Frank H., 1970, p.37).

Second, Knight differentiated between risk, a 'measurable uncertainty', and uncertainty, an 'unmeasurable risk'. The term uncertainty is restricted to cases of the non-quantitative type. For Knight it is true uncertainty, and not risk, which forms the basis of valid theory of profit and accounts for the divergence between actual and theoretical competition, (Knight, Frank H., 1970).

Thus, for this theory of profit, unmeasurable risk is in fact associated chiefly with economic change. According to this theory, if the manager were completely and accurately informed on every matter connected with his decisions, he would never incur losses, and if all competitors were so informed he would have no opportunity to make gains. In a world free from progressive change, no managerial decisions would be called for. Moreover, changes which could be predicted indefinitely in advance by every one affected would not give rise to managerial problems

or error or profit, (Knight, Frank H., 1934).

In fact, this theory seems to say that profit is an uncertain outcome of economic activity in a continuously changing environment. Economic conditions are changeable and it is impossible to predict the future perfectly. Risk arises under these circumstances; risk itself is conceived as error in decisions. Profit is a reward to managerial talent working within uncertain environment.

However, an upholder of this theory went further in his analysis and argued that both profit and loss arise in many cases from circumstances entirely apart from human foresight, and the question then is one of justice rather than of incentive. He was emphatic on

'full weight to be given to the question of moral value of different motives, of the qualities of personalty and of human relationship which go with different types of economic systems, as well as to more strictly economic issues of efficiency or even justice', (Knight, Frank H., 1934, p. 486).

One would conclude that this view on profit is identical with the Islāmic viewpoint of profit as being uncertain outcome. Thus, it is not justifiable to pre-determine interest to be given to the rentier and leaving the capital user facing all the uncertain future and the expected hazards in a continuously changing environment. So, as Knight put it, profit and loss arise in many cases from circumstances entirely apart from human foresight, and it is not 'fair' not to share the risk of the work. It is for this reason that the Islāmic *Shari'a* recommends the profit-and-loss sharing (*PLS*) system which is fair for both parties to the work.

3.3 *PLS* Institutions

3.3.1 *PLS* practices

3.3.1.1 The Middle Ages

The *shari'a* advocates the share in profit and in loss for any transaction to be undertaken by partners. That is, instead of working on the basis of *ribā*, or in terms of the current economic literature, on the basis of an *ex ante* interest rate, the Islāmic *shari'a* calls for participation in the *ex post* or the actual result of the

work. Profit sharing arrangement is consistent with the Islāmic rules of fairness as it is deduced from the Islāmic ethical principles regarding *ribā* and *Bai'*, it is *gharar-free*, i.e. free from interest.

In fact, although profit sharing is advocated by the *shari'a*, both the Middle Ages and the modern history show some attempts of applying this form of gain distribution. The forms applied were quite similar to the Islāmic modes of finance as will be shown below.

Like the custom of creating rent charges so also the mediaeval practice and theory of partnership have been explained as primarily due to the effort to escape from the operation of the usury law.

The oldest form of partnership in the Middle Ages was the *commenda* which was originally a partnership only for a particular enterprise, (Ashley, William, 1936). As early as the latter part of the tenth century, *commenda* was the practice in the commercial cities of Italy for merchants who wished to engage in foreign trade, but who did not themselves care to accompany their goods across the sea, to entrust them to agents. The travelling associate known as *tractator* or a *commendatarius*. This *commendatarius* might be rewarded with a fixed remuneration, he did not himself contribute to the capital invested in the enterprise. This form is, however, known as *mudāraba* in the Islāmic financial theory which will be explained in the next chapter.

However, a successful *tractator* would quickly be in a position to invest in trade himself, and there were examples of his contributing a portion of the capital. In such cases the division of earnings was determined by some rule as in the case of the simple *commenda*. An arrangement of this kind was more commonly known as *societas* or *collegantia*. This form is, again, similar to the Islāmic mode of *mushāraka* (partnership) with some difference that in the *collegantia* the division of earnings was lump sum, while in *mushāraka* earnings of the *tractator* is of two parts, one for management and the other for sharing in capital.

Thus *commenda* is a form of partnership, it differed in important respects from a mere lending of money. The canonist doctrine had, of course, no objection to bring against the ordinary business partnership, where each partner shared in the

management; for here the gain might be regarded as the result of labour, on the part of each, together with capital. So long as the partner who contributed only capital shared in the risk, the canonist doctrine regarded him as having a moral right to share in the profit. The canonists regarded it that so long as the capital contributor retained his ownership in the money invested, the transaction seemed clearly distinct from *mutuum* or loan which was always defined as involving a transference of ownership, (Ashley, William, 1936).

3.3.1.2 The Modern History

Generally, the above is an example of Middle Ages' *PLS* practices which are recognised by Islāmic scholars. In modern history, profit sharing was defined by the International Congress on profit sharing, held of Paris in 1889, as an agreement freely entered into, by which the employees receive a share, fixed in advance of profit, (Encyclopaedia of the Social Sciences, 1934, p. 487). The Congress interpreted this to include both legally binding agreements and those in which there was no other than a moral obligation; emphasis was upon the necessity of determining in advance the method of sharing profits. This interpretation is consistent with the Islāmic *mushāraka* in which there is no capital rentier on one side receiving an *ex ante* interest rate, and a capital user facing all the hazard of work.

As mentioned above, there were profit sharing practices in the Middle Ages. The modern movement, however, started in France in the 1840's and was given a powerful impetus by the growth of reformism after the Revolution of 1848. Businessmen were convinced that by giving the workers the opportunity to participate in profits, they would economise on materials and improve the quality of their work to such a degree that additional profits would result both for himself and for the employees. Profit sharing in England was early identified with the co-partnership movement, which implies ownership of stock by employees. The Christian socialist movement, influenced by religious convictions, appeared responsible in some degree for this emphasis on profit sharing as a means to co-partnership.

In general, in Europe, profit sharing was introduced to give incentives to workers, preventing strikes and increase output. The system was not found in Soviet Russia essentially because it seemed to be initiated by the capitalist businessmen.

While, however, in Europe profit sharing was in part an expression of the movement for social reform, in the United States it was inspired wholly by employers under pressures of labour unrest.

Thus, modern economic history advocated the merits of profit sharing as a form of sharing gains, it could encourage production and prevent discontent and strikes of workers. However, these forms of profit sharing were limited, had they been developed, they could have resulted in an equity-based economic system that could have prevailed all over the world. It is this equity-based system which is the one advocated, as mentioned repeatedly, by the Islāmic financial theory and it can be in different modes of funding like *mushāraka*, *muḍāraba*, *musāḳa*, *istisnā'* and other forms. These are the forms of finance which are examined in the next chapter.

3.3.1.3 Modern financial institutions

There are many reasons advanced in the literature for the possible instability of the traditional banking system. Proposals for reforms of this system along the lines of equity participation have been made at various times in the United States, especially during periods of banking crisis.

An example of these proposals is the one made by Henry Simons who argued that traditional banks should be replaced by two separate financial institutions. First, there would be depositors' banks which maintain 100 per cent reserves so that they could not create or destroy effective money. A second type of institutions would be in the form of an investment trust which would perform the lending functions of existing banks. Thus, Simons called for a sharp distinction between the payments and the portfolio functions of banks (Simons, Henry C., 1948).

Fisher was also a supporter of a 100 per cent reserve requirement to stop banking failure, (Fisher, Irving, 1945). Some Muslim writers have also suggested a 100 per cent reserve requirement for the same reason, (Al Jarhi, Mobid A., 1983). Friedman also agreed on the idea of a 100 per cent reserve requirements, (Friedman, Milton, 1970).

Arguments for *PLS* system have also been made in the wake of the debt cri-

sis in Latin America, particularly in Argentina, Mexico and Brazil during the 1980's. There has been a revival of proposals for an equity-based system. American economists raised the issue of the potential financial instability of a fractional reserve banking system, (Khan, Mohsin S., 1986). They argued that bank failures have more baneful implications because they affect the payment mechanism of the economy. They called, therefore, for protection of this payment mechanism and not necessarily the overall lending and borrowing operations of banks.

Hence, all the proposals made for reform are similar to the Islāmic banking system being implemented in several countries, at least on the deposit side. At the same time, however, it should be observed that the Islāmic banking system goes beyond these proposals because it requires that loans and advances made by banks are also based on equity participation.

Those who made suggestions for reform maintain that the basic flaw in the traditional system is that as a crisis developed and earnings fell, banks should seek to contract loans to increase reserves. Each bank would do so at the expense of other people. In the process some banks will become insolvent and be forced to close. They maintained also that banks tend to switch from techniques of asset management to those of liability management in the face of crisis. If banks raise interest rates to attract or retain deposits in problem situations, and if the total stock of deposits is fixed in the short-run, the process would clearly be unstable and would eventually lead to bankruptcy.

The Islāmic banking system may prove to be better suited to adjusting to shocks that result in banking crises and disruption of the payments mechanism of the country. In an equity-based system that excludes predetermined interest rates and does not guarantee the nominal value of deposits, shocks to asset position are immediately absorbed by changes in the values of shares (deposits) held by the public in the bank. Because of the *PLS* basis, the real values of assets and liabilities of IBs would be equal at all points in time. In the traditional banking system since the nominal value of deposits is fixed, shocks can cause a divergence between real assets and real liabilities and it is not clear how this disequilibrium would be corrected and how long the process would take. There is rigidity in the

traditional banking system which prevents instantaneous adjustments, and this rigidity can lead to possible instability.

The principal difference between the Islāmic and traditional banking system is not the prohibition of interest rate in the former. The difference stems from the fact that an Islāmic system treats investment deposits as shares and accordingly does not guarantee their nominal value. In the traditional banking system such deposits are guaranteed.

However, it must be admitted that a system based on *PLS* will be affected by swings in economic activity and the business cycle. But there are reasons to believe that it will perform better than an interest-based system.

The interest-based system in fact intensifies the business recession. As soon as the banks find that business concerns are beginning to incur losses, they reduce assistance and call back their loans, as a result of which some firms have to close down. This increases unemployment resulting in further reduction in demand and the infection spreads. IBs, on the other hand, are prepared to share in losses which reduces the severity of business recession and enable the productive enterprises to tide over difficult periods without a shut down.

There are changes in the real world; as soon as interest rates rise in one part of the world, capital starts moving to that part. And when the rate changes, massive movements of capital start from one country to another. Even in the same country, it moves between sectors erratically. Now, under the *PLS* system movements of capital will be guided by the expectations about profits. The point is that fluctuations in the rates of profits will be less than present fluctuations in the rate of interest. Therefore, the system from which interest is abolished and which is basically reorganised on profit-sharing basis will be more stable than the interest-based system.

Another important point is that profit-sharing ensures a fair distribution of profits, especially when high profits are achieved, which will be distributed to a large number of shareholders. When a loss incurring entrepreneur pays back the full amount plus the interest, some payment in this case will be coming out of the entrepreneur's existing wealth being effected in favour of the rentiers or in favour

of people with money. Under a *PLS* system, rich people will get more money only if their wealth has helped the society to create additional wealth, (Siddiqi, M. N., 1983).

Chapter IV

The Islāmic Banking Experience

4.1 Introduction

Muslim writers maintain that since Islām prohibits usury, it is essential that interest be avoided in any sound economic system. It is in the light of this perspective that the decision to establish Islāmic banks, (IBs) was taken.

The Islāmic revival has resulted in Muslim scholars giving consideration to ways and means of restructuring the financial system so that it might eschew interest rates. Theoretical models of interest-free banking developed by a number of writers since the early 1950's show that the function of financial intermediation could be carried out on the basis of profit and loss sharing (*PLS*), which is permitted in Islām. Enough details were provided to show that the Islāmic legal concepts of *muḍāraba* and *mushāraka* could be translated into institutionalised banking practices to suit the realities of the modern day economies. In this chapter the application of Islāmic principles and the practical experience of IBs are considered. An examination is made of how IBs have evolved to their present stage. Financial aspects of IBs, including the modes of operation of these institutions, are also discussed in this chapter, in addition to other issues influencing the development of these institutions.

4.2 IBs: A Historical Perspective

Interest-free banking was first introduced into Pakistan in the late 1950's, (Wilson, R. A. J., 1985). The institution was supported by deposits of a limited number of landowners and was not funded by the government. Poor landowners made use of these funds without being charged interest. The institution later closed down due to a shortage of funds and staff.

Another early example of a bank established along the principle of *PLS* was the Myt Ghamr Saving Bank in Egypt in the early 1960's.

The founder¹³ noticed that private banks generally concentrated their activities on the upper and middle-income classes of traders. Small savers and investors, especially artisans and farmers in the rural areas, were generally neglected.

The savings bank began work in 1963. It extended short-term credit on an interest-free basis and charged only administrative expenses. The bank had to observe the prohibition of *riba*. The main purpose of the bank was initially to supply its members, i.e. depositors, with the short-term credit needed to cope with seasonalities in their income. The bank's credit enabled borrowers to acquire command over real resources, since it linked savings and entrepreneurship.

In response to the emerging demand, the bank's business was soon expanded. More fundamentally it changed the ethos of banking in the minds of the rural population. The bank continued working until 1967 when it was wound up. It ran out of funds because it did not share in the profits and it lacked staff.

The experiment in interest-free banking was revived again in 1972 in a modified version. The Nasir Social Bank was established on a wider base and was funded by the Egyptian Government. The bank's activities extended to other banking services, in addition to raising deposits and providing interest-free loans.

These were the first experiments in interest-free banking which facilitated the spread of IBs. Another factor which helped to further the development of IBs was the financial surpluses in the Muslim world, particularly after the 1973 oil price increases.

In 1975 the Islāmic Development Bank (IDB) was established in Jeddah in order to provide development financing. People – especially in the Gulf states – wanted to make use of the post-1973 surpluses through the financial sector, which was dominated by interest-based banks. As a result, a number of Islāmic institutions were established, the first being the Dubai Islāmic Bank in 1975, mainly owned by private shareholders. In 1977 another Islāmic financial institution was founded in Kuwait, the Kuwait Finance House. It was supported by the government and concentrated on large-scale project financing. This was followed in 1979 by the Bahrain Islāmic Bank. After that, two large Islāmic financial institutions

¹³ Dr. Ahmed El Naggar, was the chairman of the International Association of Islāmic Banks, (IAIB).

were founded, the Dar al- Māl al- Islāmi and the Al Baraka group. There are now no less than fifty two IBs all over the world.

The development of IBs was affected greatly by regulatory measures in the countries where they operate. IBs started in the 1970's in Muslim countries with conventional banking systems. In some countries, IBs were set up through the introduction of special laws exempting them from a number of existing banking rules. Other Islāmic institutions were set up through the support of non-banking governmental entities. However, as a result of the increasing impact of IBs, central banks sought to regulate their activities; consequently, the central banks resorted to the legislative authorities in order to bring the IBs under control.

The relationship between the IBs and the monetary authorities in different countries is still unstable. Unsolved issues remain which affect adversely the work of IBs both inside or outside Muslim countries. The implications of these issues are magnified when IBs seek to participate in international stock markets. These issues affect IBs especially when they act as investors in non-Muslim countries. The development of IBs was also affected by the press campaign, particularly after 1982 when two leading Islāmic financial institutions incurred losses.

4.3 Methods of Islāmic Financing

It was mentioned in the previous chapter that the prohibition of *ribā* occupies a central position in Islāmic *Shari'a* law. However, the prohibition of *ribā* has deeply affected every-day life, and the requirements of commerce have given rise to a number of methods of evasion, (called *hiyal* in Arabic language). Thus some Muslims, though they are pious, frequently take bank interest. This part of the thesis, shows how the *PLS* system, which is permitted by the *Shari'a*, could be applied by IBs in their bilateral relations with customers, i.e. as receivers of deposits or as investors of these funds.

In dealing with the practical issues raised by an Islāmic banking system, the concentration shall be here in this section on the methods of raising funds and the ways in which they are allocated by IBs given that a developed broad financial market operating in accordance with Islāmic tenets has not yet been developed.

The implementation of the *PLS* system raises problems mainly with respect to various forms of IBs' lending operations. Banks and other financial institutions provide finance on the basis of participation in profits and losses using instruments and techniques such as *mudārabā*, leasing up, *ijāra*, mark-ups in prices (*murābaha*) and hire purchase. The principle of *PLS* is also applied to the liability side of financial intermediaries, since there are various kinds of account, including deposit accounts, investment accounts and saving accounts.

When IBs work on the basis of interest-free tenets, there are three parties: (i) the actual user of the capital or entrepreneur; (ii) the bank, which serves as a partial user of the capital funds and as an intermediary link; and (iii) the supplier of savings or capital funds, i.e. the depositors. There is a triangular relationship between the actual entrepreneurs, the bank and the depositors. One link in the *mudārabā* partnership will be between depositors and the bank, the other between the bank and the ultimate users of the funds. What follows is an explanation of the two links of the *mudārabā* partnership. It is worth mentioning here that the status of the Islāmic bank in relation to its clients is that of a partner, an investor or a trader, whereas the conventional bank's relationship with clients is that of a creditor or a debtor.

Where normal banking practices do not contradict Islāmic principles, IBs adopt the current banking tools and procedures. Where this is not the case, IBs have devised their own tools and procedures to accomplish their banking activities. There now follows an examination of the methods of savings mobilization used by IBs.

4.3.1 Fund-raising activities

IBs receive two types of deposits: (a) deposits not committed for investment, which take the form of current accounts or saving accounts; and (b) deposits committed for investment, which are called investment accounts.

4.3.1.1 Current account deposits

A current account is operated in the same way as it is managed in the conventional banking system. Current account deposits are owned by different sec-

tions with primarily the 'transaction motive' of keeping the excess liquidity readily available so that the depositors can write cheques on these accounts, thus finding a convenient method of spending and making payments. However, since the motive of the depositors is not to earn any profit or income, the banks generally do not and need not pay any return on this category of deposits. Funds mobilized in current accounts can legally be used to meet short-term financial needs only, such as balancing the liquidity position; they cannot be used for long-term finance.

4.3.1.2 Saving deposits

Money is deposited in savings accounts primarily in order to earn income and secondarily to provide protection against unexpected future expenditures. That is, the primary motive is precautionary while the secondary one is an investment motive. Therefore a savings account has to fulfil the function of an investment as well as a current account. Although depositors allow the Islāmic bank to use their money for long term purposes, the bank guarantees their value only and is not obliged to pay any returns. However, most of the IBs either pay cash reward from their profits at the end of the financial year, or give certain privileges to the holders of these accounts, e.g., by providing financial support for small projects, selling consumer durables or producers' goods by instalments, or distributing gifts. The rewards are discretionary and are paid only when the bank is earning substantial profits. Thus IBs savings accounts are not substantially different from current accounts except that in the case of savings account, a book showing the balance is kept by the depositor, while the current account holder can obtain information on his/ her balance only at the bank. Since cheques are drawn on current accounts, only the bank can maintain an up-to-date record.

Some Islāmic scholars believe that since funds deposited in saving accounts are invested on a *PLS* basis, they are viewed as part of the investment account; otherwise, as they argue, it is meaningless to reward deposits. This was specifically an opinion of Mohammed 'Ūzair in the 1950's; today he holds the idea that banks can invest these funds and credit the income thus earned to the account of depositors on a *pro rata* basis, ('Ūzair, M., 1980).

4.3.1.3 Investment Accounts

Depositors with these accounts are concerned with earning profits rather than holding funds for precautionary or transaction purposes. The primary motive of the depositors is the 'investment motive' or 'finance motive'. In other words, to earn some income from idle funds during the period that they themselves do not utilize those funds in their normal business operations. The secondary motive may be 'precautionary'. The funds raised in investment accounts are invested by banks on the basis of the *PLS* principle. IBs share the amount of profit from their investments with depositors. The basis of distribution is a bank's overall profit and loss position if deposits are unconditional and of a long-term nature, although some IBs such as the Kuwaiti Finance House offer unconditional deposits linked to a particular project. The Jordanian Islāmic Bank, on the other hand, has introduced specified accounts so that profit and loss for deposits in these accounts are calculated only on the performance of the projects, (*Financial Times*, October 4, 1978, p. 33 & July 15, 1981, p. 23).

Funds deposited in investment accounts may, however, result in losses. Depositors are liable to suffer losses in the same proportion as they share profits. Savers have to forgo earnings on their savings, and might possibly lose part of their deposited amounts. In this sense, depositors are like shareholders who lose some or all of their shares if the bank goes bankrupt. But the shareholders are members of the General Assembly and are vested with the power to criticize the management of the bank, a right which is not given to the depositors. Moreover, unlike shares, investment certificates are not tradeable and this may imply more risk to depositors who cannot dispose of their certificates except through the bank. One more difference between depositors and shareholders is that dividends on shareholders' stock would be discretionary on the part of bank management, whereas depositors' investment always yield a constant proportion of profits.

Investment accounts can be of two types:

Accounts with authorization in which the account holder authorizes the bank to invest his money in any one of its projects, receiving profit at the end of a specified period.

Accounts without authorization in which the account holder may choose a particular project in which to invest. He is also free to determine the period of deposit. Profits of the chosen project are distributed between the two parties according to an agreed percentage. If the investment account is opened for a fixed period, the customer is not allowed to withdraw before the end of the specified period. For instance, the Faisal Islāmic Bank (Sudan) and the Taḍāmon Islāmic Bank (Sudan) both specify three months as a minimum period for an investment deposit to be entitled to a share in profits. It should be mentioned here that whereas savings accounts have attracted relatively few deposits, investment accounts have been able to attract substantial investment deposits.

However, problems are likely to arise with regard to information costs to those wishing to place funds in investment deposits, (Khan, M. and Mirakhor, A., 1985). In the absence of a single interest rate, there would be an increase in the information cost. Savers would have to collect information on different rates of return offered by different banks, i.e. to evaluate the relative performances of various banks. In the case of traditional banks, depositors would have information directly on time – and saving – deposits with a known interest rate. For IBs to reduce these information costs they need a secondary market in which to trade investment deposits. By pricing, this market would help investment depositors to gather information on the current and expected performance of banks. So long as the economies in which IBs work do not develop these markets, this will be one of the problems that IBs will continue to face.

So far IBs have been seen as financial intermediaries in the mobilization of savings from the public on the basis of *mudāraba*. These funds are advanced as capital to entrepreneurs on the same *PLS* system. Profits accruing to entrepreneurs on capital advanced are shared by the bank at a mutually agreed percentage. Making allowances for administrative costs, the net revenue on all these accounts constitutes the profits of business. This is distributed over the entire capital involved, i.e. public deposits held by IBs on the basis of *mudāraba* and the banks' share capital.

If the net revenue of the bank is a negative quantity, the loss is distributed equally between share capital and *PLS* deposits; according to the nature of this

system, depositors are liable to bear losses should they materialize.

4.3.2 Profit-earning activities

In the traditional western system, financial institutions, companies and other economic units in the financial market raise funds mainly by issuing equity shares or bonds or by medium-term and long-term borrowing from banks at fixed interest rates. These methods of financing are, however, at variance with Islāmic principles.

A number of Islāmic countries have taken steps to bring their financial systems into line with Islāmic tenets: Iran and Pakistan are two examples. A number of laws have been passed in these countries to base financial transactions on the *PLS* principle. For instance, Pakistan introduced participation-term certificates to replace interest-bearing bonds. Banks and other financial institutions are asked to grant long-term loans on a *PLS* basis to provide long-term finance to industry and commerce.

Since they cannot earn interest by lending money, IBs have to undertake investment to earn profits. As mentioned above, a large number of depositors enter into individual *mudāraba* contracts with the banks, organized on the basis of share capital, and contracts stipulate the share of the profits. IBs assume the role of financier-entrepreneur in providing capital to the businessmen. The latter then share with the IBs the profits of their productive enterprise.

4.3.2.1 *Mushāraka* (Partnership)

The *mushāraka* contract is bilateral agreement between the financial institution and the user of funds; it is not documented in the form of a negotiable instrument and cannot be traded like other financial assets on the market, (Iqbal, Z. & Mirakhor, A., 1987).

The Islāmic bank and its clients agree to participate in a joint operation over an agreed period of time. Both parties contribute to the capital of the operation in varying degrees and agree to divide the net profit in proportions agreed upon in advance. *Mushāraka* is similar to the *societas* practised in the Middle Ages in Europe.

There is no set formula for profit sharing. In medium and long-term operations, a self-liquidating form of participation can be agreed upon, whereby the ownership of the whole project may pass either to the customer or the bank. The bank may also participate permanently in any establishment, building factory, or agricultural project, until the liquidation of the firm. The bank may also participate temporarily, promising to withdraw its share by selling to partners who pay the bank amounts as a lump-sum instantly or on instalments as per mutual agreement among them.

As mentioned above, the profit-sharing arrangement is dependent on the expected profit, which is adjusted according to the performance of the project. In return for his managerial responsibilities, the client receives an agreed proportion of the expected profit, and the remaining balance is divided between the two parties according to their degree of participation in the capital.

In the Sudan, IBs give the clients about 35% of the total profits as a reward for their managerial responsibilities. Losses are shared between the two parties in proportion to their contribution to the employed capital.

Mushāraka is also applied to activities other than those involving long-term capital; it is used to fund the working capital requirements of the trade and industrial sectors.

4.3.2.2 Muḍāraba (*quīrād*)

This is a form of financing similar to the *commenda*, one of the oldest forms of partnership practised in the Middle Ages in Europe (see the preceding chapter).

In this type of investment, the bank takes care of the financing while the customer contributes only his managerial effort or labour in return for an agreed proportion of the profits actually realized. This arrangement places human capital on par with financial capital. In both *muḍāraba* and *mushāraka*, both sides stand to gain, depending on the actual performance of the operation. Under *muḍāraba* arrangements, the partner offering his effort will lose his labour in case of financial loss incurred from normal business conditions; but he is responsible for the loss of capital should this be a result of negligence or a wilful act. The bank, as the

provider of capital, bears all the financial risks; this in itself justifies the bank's claim to its share of the profits. To safeguard against negligence or intentional acts by the client, the bank may require a guarantee. An essential difference between *mudārabā* and *mushāraka* is the number of parties involved in the transaction; in the latter there is more than a single contributor of funds.

Legally, *mudārabā* denotes a business in which one person participates with his money and the other with his effort and skills. It can be of two kinds: **multi-purpose** *mudārabā*, with more than one specific objective; and **specific-purpose** *mudārabā*. Banks can either engage in direct lending, or can make loans indirectly through companies set up superficially to engage in *mudārabā* financing. Risk capital for the *mudārabā* company is provided by banks in the form of direct equity, or through loans with equity features (Khan, M. and Mirakhor, A., 1985).

In Pakistan, Islāmic financial institutions have developed a *PLS* instrument of finance, the participation-term certificate (PTC), which is designed to replace fixed interest-bearing bonds. The PTCs are transferrable corporate instruments based on the principle of *PLS*. They have a specified maturity period that may not exceed ten years, excluding the period of grace, and are secured by the legal mortgage on the fixed assets of the company. Proceeds of PTC are used exclusively for implementing the intended project. In order to control the use of funds, a trustee is appointed with wide-ranging auditing rights. The PTC holders share in the profits of the company on a basis determined by mutual agreement between them and the company management, (Gazette of Pakistan, January 1981).

4.3.2.3 Trade Finance

(i) *Murābaha* (Mark-up)

Under the *murābaha* arrangement, the bank arranges for the purchase of goods requested by the customer and sells them to him on the basis of cost plus the agreed profit margin. The customer guarantees the bank a delayed payment upon fulfilment of the actual purchase. In order to avoid interest (*ribā*) some banks will not demand any legal obligation on the partner to buy goods. Therefore the customer can stop buying goods from the bank, and the risk is still that of the bank. There is, however, the practice of financing a mark-up with the

obligation on the customer to buy the goods, which is followed by all IBs in the Sudan. Specifically, for the mark-up system to be consistent with Islāmic law, the transaction must satisfy two conditions: Firstly, the bank, as financier, has to take physical possession of the goods being financed for the borrower. This ensures that the lender is exposed to some degree of risk. Secondly, the rate of mark-up should not be tied to the length of the period over which the financing is to be provided. A mark-up arrangement is used most commonly in foreign trade and short-term transactions for purchasing raw materials.

(ii) *Bai' Salam* (Post-Delivery Sale)

The bank buys certain goods on post-delivery and pays the cost instantly or sells certain goods on post-delivery and receives its cost immediately. Under this procedure, costs are fixed and paid in advance but the delivery of the sold item is postponed or delayed for a certain period. Similarly, the place of delivery, the costs and quantity of the sold goods should also be fixed and defined as they are conditions for such a sale.

(iii) Hire-Purchase (Leasehold)

This is another system that enables IBs and other financial institutions to provide medium and long-term finance. With leasehold, an Islāmic bank acquires certain fixed assets such as machinery and leases them for a specified period to the customers for a hire fee. The main feature of this arrangement is that the lessor (the bank) retains the ownership of the asset, while the lessee (the entrepreneur) has the possession and use of it. The procedure may also be converted into a reduced renting procedure whereby the customer, by paying every year an instalment of the value of equipment/ physical capital, reduces the rent until the whole equipment is owned by him and the rent is eliminated.

One question raised by the hire-purchase system is this: how are the rentals to be tied to the profits and losses of the lessee so as to harmonize the leasing system with the partnership principle. Some writers suggest making lease or rental payments a certain percentage of annual profits assigned to the assets leased; however, banks might face difficulties if the number of assets leased was high and the value of single items was low compared with the total amount of funds provided. One

suggested solution is, however, to relate rentals to the output of an asset, (Karsten, I., 1982).

(iv) *Muḍāraba* Certificates (Islāmic Securities)

These are financial instruments issued not for any specified project. A *muḍāraba* (participation) company issues certificates which are receipts for the money received and a guarantee by the *muḍāraba* company to reimburse the proceeds of the company, if any, to bearers of certificates at the date of maturity and according to the amount with which he participates.

Muḍāraba companies invest these funds in different businesses according to the *Shari'a* rulings. In the Sudan, the Islāmic Investment Company (Sudan) issues the *muḍāraba* certificates with a maturity of between three months and one year. It places these mobilized resources only in productive sectors – agricultural and industrial interests.

(v) IBs also provide interest-free loans (*quarḍ hasan*). These are granted on altruistic grounds to individuals and governments. The banks receive only the principals of loans given but the Islāmic Development Bank applies also service charges.

The above are the most important kinds of operation in the IBs. There are, however, other means of finance which can be developed as *muzāra'a* and *musāqā* (kinds of agricultural credits). According to the former, IBs can provide agricultural lands that they own, or which are otherwise in their possession, to farmers for cultivation for a specific period in return for a pre-determined share of the harvest. Banks may also provide seeds and fertilizers along with the land if they so choose.

Under the *musāqā* arrangement, banks may provide trees to farmers for a specific period of time and a pre-determined share of the harvest.

These are, then, what one may call the 'lending operations' of IBs. These operations are not problem-free. For instance, IBs have not yet developed feasibility study techniques to apply to the projects selected for financing. The forecasting of profits and losses needs to be closely scrutinized, since IBs receive no interest

on their provision of finance and share only in the expected profits. Therefore if the projection of profits is not accurate, IBs will definitely experience losses.

Given the diverse methods of Islāmic finance, IBs have to determine which of these methods are effective for resource allocation in the long-run and which are appropriate for short-term financing. This requirement is crucial in order that IBs can use their mobilized funds in a way that is compatible with the methods of finance. More precisely, IBs need to manage their portfolio efficiently so that they can contribute significantly to real production and development and realize adequate profit levels.

IBs carry other income-generating operations which are in effect banking services, such as issuing letters of credit, letters of guarantee, discounting negotiable instruments.

4.4 IBs: some problems

4.4.1 Portfolio management

The behaviour of economic agents in any country is determined partly by past experience and present constraints. In some countries participants in the financial system are generally subjected to different constraints, while in other countries they are subjected to only a few constraints on their behaviour.

The Islāmic banks are still growing in experience. Regarding constraints, IBs in different countries, particularly in those economies where the banking sector is not fully interest-free, do not freely choose arrangements which best suits their interests. As a result, their activities are not demand-oriented and do not react flexibly to structural shifts in the economic setting as well as to changes in preferences.

Following the sediment theory¹⁴, IBs' management know that a certain portion of the short-term fund is normally not withdrawn at maturity; these funds could be used for medium or long-term financing, and as a consequence the average

¹⁴ The sediment theory is based on the assumption that a certain core of funds always remains with banks over longer period of time. In contrast, is the golden rule of banking which implies that short-term deposits should be used to finance only short-term lending, and that long-term lending should be financed only by long-term deposits and other long-term sources of funds.

maturity on the asset side of balance sheet is longer than on the liabilities side. However, a precondition for this maturity transformation is that the bank be able to obtain liquidity from external sources in case of unexpected withdrawals. Some writers mentioned that without an interest-free money and capital market, IBs have no adequate instruments to meet this pre-condition for effective maturity transformation, (Nienhaus, Volker, 1986).

To overcome these difficulties, some Islāmic bankers such as Dr. Hassan Al Ani, from the Islāmic Development Bank in Jeddah, have proposed a new type of financial certificate which is in accordance with the Islāmic law. But these certificates are legal according to the *shari'a* only when they represent the ownership of real assets. IBs can issue certificates upon income generating real objects and it is possible to calculate the present value of the expected future income. Siddiqi proposes that in the event of unusually large withdrawals, IBs can seek temporary financial accommodation from the central bank on a *muḍāraba* basis, (Siddiqi, M. N., 1983). Moreover, IBs could seek assistance from other IBs to tide over the temporary liquidity shortage.

It is true that term transformation involves the risk that the institution may not have sufficient reserves if short-term deposit account holders unexpectedly withdraw their funds. Similar problems of illiquidity can arise if loans are not repaid on time. But IBs can undertake a certain degree of term transformation without endangering their liquidity so long as deposits maintain a moderately steady growth. Moreover, IBs can arrange withdrawals, particularly from investment accounts. Thus there is always a core of deposits that remain with IBs and can be invested in a more suitable way. The degree of stability of these core deposits helps to determine what portion of resources available in the current period can be relied upon to remain available over future periods.

IBs can enhance term transformation if there is an interest-free bank market or a secondary market for Islāmic financial papers. Adequate financial mechanisms still have to be developed, without which financial intermediation, especially the risk and maturity transformation, is not performed properly. Where IBs can have access to short-term funds in domestic or international markets, this will relieve the pressure on their liquidity.

4.4.2 Conflict of interests

It is often argued that conflicts of interest will occur frequently unless IBs embrace a wide range of banking services and consequently greater portfolio and service diversification.

The evidence suggests that funds supplied to banks are determined mainly by the extent of bank's services and the volume of its investment activities. Funds are also affected by the expected return to depositors and shareholders and the level of risk involved. B. A. Bashir mentions that to ensure the future success of IBs, they must be well managed to fulfill the customer's objectives. These include: (a) an efficient banking service; (b) cheap and less risky loans on participation; (c) high return to customers on their investments; and (d) a low risk of zero returns, (Bashir, B. A., 1982). He adds that this would be simple if they were also the overall objectives of the bank. But if the achievement of high returns to equity shareholders of the bank is also an important objective then the task becomes more difficult. He attributes this difficulty to the contradiction between customers' objectives (those of particular depositors) and the maximisation of returns to equity holders.

At the core of the problem is the choice between a strong liquidity position with, consequently, less profitable investment, and a less liquid position, but with profitable investment. The first alternative satisfies the depositors' need for a profitable and efficient banking service, whilst the second is preferred by shareholders since it guarantees high returns.

In other words, a low profit-sharing ratio with a less profitable portfolio will increase banks' liquidity but will result in a low profit ratio and vice versa. But high profits to satisfy the return objectives can be achieved only with high risks, and in the case of IBs high risk would simply lead to the failure of the bank. This is because, as Bashir has said, depositors can draw their funds from the bank before losses are incurred. He concludes that there should be an optimal policy to reconcile the objectives of depositors and equity holders. But if shifts from the optimal policy are to occur, he suggests that they have to be in favour of more profitable banking services and short-term investments, and if necessary also a

higher profit-sharing ratio rather than through long-term investments and a low profit-sharing ratio to depositors, (Bashir, B. A., 1982).

It is correct that IBs should adopt an optimal policy, but this should not favour depositors at the expense of equity holders for the following reasons:

Firstly, depositors will not withdraw their money if they expect to lose, because investment accounts in IBs are conditional with respect to the minimum period and minimum amounts of deposits. Moreover, the system is dependent on the *PLS* basis.

Secondly, some IBs such as the Faisal Islāmic Bank (Sudan) and the Faisal Islāmic Bank of Egypt are supported by a large number of shareholders from middle and lower-income groups. Therefore, by the same reasoning, they will be discouraged by low profit ratios if the banks concentrate on services only.

Thirdly, one study has disclosed that regression results on the stability of demand, time and savings deposits for a selected number of developing countries suggest that a high percentage of nominally short-term funds such as demand deposits can be relied on to remain available over more than one period. In a number of cases the core of demand deposits is larger than that of time and savings deposits combined, (Khatkhate, Deena R. and Klaus Walter, 1980). These results indicate clearly that an important percentage of financial resources which are usually considered short-term can be used for longer-term lending without endangering the liquidity of an institution. But this conclusion is based on the stability of IBs' lending side; arrears in loans or defaults may cause problems in the banks' uses of resources.

To conclude, an optimal policy is needed to serve the objectives of both depositors and equity holders. For IBs working in developing countries, the need for such a policy is important because of (i) the greater preference of savers there for liquidity assets; and (ii) the importance of higher capital formation for growth.

This optimal policy could be attained through a proper term transformation of financial resources, which in turn could be enhanced by devising flexible financial instruments. In Islāmic economic thought there are different modes of financing characterised by a high degree of flexibility and specificity, (Wilson, R. J. A., 1988).

4.4.3 The regulatory environment

The relationship between IBs and the monetary authorities is a delicate one. For IBs in different countries an important institution is the central bank. The central bank exercises authority over IBs under laws and regulations engineered to control and supervise traditional banks whose goals and functions are less comprehensive and different from IBs. IBs came into existence in an environment where the laws, institutions, training and attitudes are set to serve an economy based on the principles of interest. The operations of IBs are concluded under contracts which actually do not come fully under the jurisdiction of the existing civil laws. If there are disputes to be handled, civil courts are not sufficiently acquainted with the rationale at the heart of these contracts.

Doubts have been expressed about the ability of IBs to conform to the criteria of banking authorities in the West. The banking laws of the West differ from country to country, but even in those with less restrictive laws such as West Germany, the authorities have not yet granted licence to any Islāmic financial institution, (Nienhaus, Volker, 1986). One of their arguments is that the protection of depositors, which has the highest priority for the German banking authorities, is insufficient in Islāmic financial institutions.

Regarding the protection of depositors, IBs are required to let the authorities know the difference between money paid into current accounts and money paid into investment accounts. IBs operate two broad types of deposits: (a) deposits which cover transaction balances. These have a 100 per cent reserve requirement and are completely safe, thus satisfying the needs of risk averters; (b) the *PLS* or equity account, in which depositors are treated exactly as if they were shareholders in the bank. There is no guaranteed rate of return or nominal value of the share.

In the United Kingdom, the Bank of England is very stringent in granting licences for IBs to operate. Under the British law, the 1979 Banking Act lays down restrictive requirements for the management and owners of licenced deposit takers. In order to be established in England, IBs must also meet the requirements of the Department of Trade, the Customs and Excise authorities and the Inland Revenue. So apart from legal constraints there are economic measures which restrict operations of IBs in the non-Muslim world.

IBs operations in Muslim countries also face legal and economic restrictions. For instance in the Sudan IBs are not allowed to use their resources in certain areas of economic activity. Moreover, strict measures on foreign currency dealings are unfairly applied on IBs there.

Finding acceptable investment outlets is a major challenge for Islāmic financial institutions. The Islāmic banking movement has given substantial funds to the international financial system but much more narrowly than it had hoped. IBs are constantly trying to find ways to diversify their activities without transgressing the *shari'a*.

4.4.4 Inadequate staff

IBs do not have a high degree of expertise in the evaluation of projects. This inability to evaluate the profitability of projects may tend to militate against profitable projects.

IBs relied initially on staff who were trained in traditional commercial banks. They need to be given intensive courses in the workings of *shari'a*, basically explaining the rules which govern economic activities in Islām. The personnel needed by IBs should not only be well qualified and competent, they should also be committed to the cause of Islām.

4.4.5 Planning

The planning of future policies is a problem especially for financial institutions operating in developing economies. This is particularly serious when government policies cannot be predicted with any degree of certainty.

Successful planning is dependent largely on information drawn from past experience, matched with adequate knowledge. In view of their short history, IBs are at a disadvantage compared with traditional banks. The evaluation of the appropriateness of any financial transaction rests generally on a thorough assessment of alternatives. Hence a considerable amount of information is necessary. In this regard IBs are expected to exchange information between themselves and to expand the circle of co-operation with other non-Islāmic financial institutions. The International Association of Islāmic Banks can occupy a central position as the

conductor of this information so that the related cost-advantage of an individual institution in an Islāmic banking system translates itself into the more efficient use of existing scarce resources for the benefit of the economies within which IBs operate.

Chapter V

The Sudanese Economy: Structure And Development Performance

5.1 General Features

According to the United Nations' terminology, the Sudan is one of the least developed countries (LDCs). It is distinguished among LDCs with its vastness and low population density. The Sudan shares with LDCs most of their economic and related characteristics, these are: (i) the low per capita income, (ii) low growth rate, (iii) retarded economic development because of poor physical infrastructure, lack of trained man-power and a shortage of resources for investment, (iv) dual economic structure.

A dual structure implies the existence of both traditional and modern sectors. A large part of the population is engaged in primary economic activities following a traditional pattern – depending on hand-operated irrigation methods or rainfall. The modern sector, on the other hand, adopts power-operated methods of irrigation and the use of mechanical implements, (Lees F. A., & Brooks H. C., 1977).

In the Sudan, there is an enormous potential for development. The country is the largest territorially in Africa and Arab World, with 2.5 million square km including 12% agricultural and 30% forest. Out of the total area of approximately 597 million feddans¹⁵, it is estimated that 85.5 million feddans are arable land. Of the total arable land, only 20% is under cultivation. The climate is diversified with water provided by the two (white and blue) Niles. All these conditions are favourable for an expansion of agricultural and other economic activities.

Compared to its land resources Sudan is relatively sparsely populated. The population, currently being about 23 millions, is not evenly distributed. Population

¹⁵ Feddan is approximately equivalent to 1.05 acre.

density is approximately 9 inhabitants per square k.m. With this thin and dispersed population and the vastness of the country, transport and communications have been constituting a major problem in the development process.

Another important feature is that, almost all non-traditional economic activities are dominated by the public sector. The government owns and operates all the public utilities, railways, electricity ... etc. It monopolises internal and external trade in certain basic commodities including sugar, wheat, cotton and cement. It also occupies a central position in industry and services.

The Sudanese economy is an underdeveloped one. Recalling that the manufacturing subsector is supposed to be the most dynamic of all sectors in terms of affecting the growth process, its share in GDP is less than 10% (see Table 5.3). Another evidence of underdevelopment is the disproportionate increase in the share of services sector – a supposedly unproductive sector. The Sudanese economy is classified as a non-industrialised one with a value added share of less than 20%.

The underdeveloped structure of the economy could also be ascertained from the distribution of the labour force over the major sectors. According to information relating to 1980, the share of agriculture, industry and services sectors in the total labour force is reported as 78%, 10% and 12% respectively, (Ali, A. A. G., 1985). In the World Bank's Reports figures are slightly different. The share of industry was counted as 3.5% only. In 1973, agriculture absorbed 72.7% of the labour force, while industry absorbed 4.7%. These results, when compared with the figures in 1980, show that agricultural activity dominates in the main occupations. The work force engaged in manufacturing is very small.

The economy is dependent on agriculture, and more specifically on cotton as its principal cash crop. As recently as 1979 cotton accounted for 65% of export revenue and in 1983 it accounted for 49%. This percentage declined in recent years, it was only 30.4% in 1987, (Economic Survey, 1987/88). The disadvantage of economic dependence on such exports have been critical because of the wide fluctuations of commodity prices on world markets and the inequality between price levels for commodity exports and those for energy imports or imports of manufactured goods. Yet, there is little progress made towards diversifying the economy. The textile industry, for example, like manufacturing in general, has been hampered

by lack of spare parts and shortages of power supplies, due in turn to the lack of foreign exchange.

Since the mid-1970's, Sudan's own supply of skilled workers has been depleted severely due to the emigration to the oil-rich Gulf countries. The external debt has been soaring continuously. Civil war in the south has been hampering exploitation of oil and water resources.

5.2 The Sudanese economy and Economic Planning

Sudan has a history of interrupted development plans. A ten-year plan for the decade to 1969-1970 was announced in 1961. During the latter half of the 1960s performance deteriorated and by 1967 the plan had been effectively abandoned.

The then new government, coming to power in May 1969, set a new plan to cover the five years – 1970/1975 and this aimed at total investment of LS. 370 millions to increase GDP by 8.1% a year. By June 1974, it was decided to bring in a two-year interim programme on to the existing plan to extend it to 1977. The government did this because it felt that the oil wealth in Arab countries could be attracted.

As a consequence, in the mid-1970s, the famous 'breadbasket' plan was adopted. The Arab Fund for Economic and Social Development (AFESD) in Kuwait studied the feasibility of a 25-year agricultural investment programme in the Sudan. The objective was to meet a large proportion of Arab requirements of wheat, sugar, vegetable oil, feedstuffs and meat.

The Arab Authority for Agricultural Investment and Development (AAAID) was set up to channel Arab money into Sudanese agricultural projects. Two development phases were set out, the first covering the ten years to 1985, and 100 projects were devised to be funded by public and private sources. 60% of these projects were to be carried out during the course of Sudan's own six-year development plan for 1977-1983, launched in July 1977. However, AAAID suffered many problems among which was the increasing prices of sorghum especially in late years. By the time of its annual general meeting in 1985, AAAID's seven subsidiary companies had recorded losses estimated at some U.S.\$ 80 millions.

Sudan's own plan for 1977-1983 was said to represent the first phase of an 18 years programme for the period up to 1994-1995. It aimed at overall investment of LS. 2670 millions and an average annual GDP growth rate of 7.5%. Annual growth of 6.5% was the aim for agriculture, with industry projected to grow at 9.5% a year.

This plan too, was ill-fated. It had just begun before balance of payments problems caused by a 78% increase in the trade deficit between 1977 and 1978. This situation forced Sudan to turn to the IMF and it unwillingly initiated a series of three-year austerity or stabilisation programmes for the period 1978-1983 and up to 1984-1985.

The three-year plans were intended to rehabilitate existing plant and agricultural schemes, consolidate and expand infrastructure, correct price distortions that had constrained cotton production, and partly by increasing cotton production to improve the balance of payments. The IMF sponsored a decision to encourage cotton production – at the expense of wheat output– to generate foreign exchange.

Unfortunately, the introduction of incentives for cotton farmers coincided with very serious floods which destroyed farms and cotton plantations and washed away irrigation canals. Latter, just as cotton exports was to show signs of revival after the poor harvest of 1978, Sudan was hit once again by a second round of oil price rises in 1979/1980. The import bill more than doubled between 1980/1981 and 1982/1983, taking the foreign trade deficit over LS. 1 billion. Oil imports were equal to more than half the total value of all exports. At the same time, high interest rates were compounding Sudan's debt problem. The external debt has more than trebled over the years 1981-1987 to reach a figure more than U.S.\$ 10 billions and has become the single most important issue facing the economy.

Rescheduling was encouraged in the early 1980's by the prospect that oil discoveries in the Southern Sudan would be exploited to replenish financial and economic positions of the economy. In fact, inefficiency in management, transport problems, political instability in the southern region of the country and drought, all these factors affected the economy performance adversely. The past regime was overthrown in April 1985 and a transitional government came in power. It suspended the previous three-year plans and launched a one-year development budget for the

year 1985-1986. However, by February 1986, when Sudan had failed yet again to pay some long delayed arrears to the IMF, it was officially declared illegible for further IMF borrowing. The Sudan faced a reduced capital inflow from abroad.

In April 1986, a new government has been elected. It was only recently that the IMF agreed with the government on a new economic programme. The IMF team negotiated a new rescheduling package. The proposed four-year recovery programme – called the economic salvation programme (ESP) – was discussed. The main subject was, however, the repayment of the estimated U.S.\$ 375 millions of arrears to the IMF. One important issue was the unification of the exchange rate, but the IMF endorsed this medium term ESP when the Sudanese pound was devalued from U.S.\$ 1 = LS. 2.5 to U.S.\$ 1 = LS. 4.5, i.e. a devaluation of 80%. The ESP was intended to recover and rehabilitate the national economy to cover the period 1988-1991. Its principal objective is to provide the minimum necessities of life, restore environmental balance, develop natural resources and introduce administrative and institutional reforms, (E. I. U., COUNTRY REPORT, No. 1, 1987).

The new government (being in power since June 1989) plans to launch a new interim development programme, starting in January, 1991, and would continue for three years. Characteristics and details of the programme have not yet been disclosed. In general, it would appear that the development programme would be similar to the preceding programmes, especially the last four-year recovery programme.

5.3 The Overall GDP Growth Performance

5.3.1 GDP growth rates

Statistical problems surrounding national income accounts are usual in the Sudan. Estimated figures are therefore not reliable.

Generally, real economic growth has been erratic. The average annual growth rate of the GDP was 0.7% during the period 1960-1970 and increased to 6.3% during the period 1970-1982, -0.7% during 1980-1985 and -0.1% over 1980-87, (The World Bank, Development Reports). But the high average GDP growth

rates during the 1970's reflects to a large extent price increases rather than real growth rates as there is no official GDP deflator.

In the course of the years 1978/79-1984/85, growth rates for the Sudanese economy had been unstable. In absolute (nominal) terms, the GDP shows an upward (but fluctuating) increase, (Table 5.1). In real terms GDP shows negative growth rates.

Table 5.1: GDP* and GDP Growth Rates

Years	GDP (LS. million)	Annual (absolute) increase (%)	Deflated <i>CPI</i> * %	GDP/CPI %	Real growth rate (%)
1970/71	761.1	-	-	-	-
1971/72	832.4	9.4	112.9	7.4	-
1972/73	896.8	7.7	128	7.0	-5.4
1973/74	1246.2	39.0	155	8.0	14.3
1974/75	1510.8	21.2	191.8	7.9	-1.3
1975/76	1848.0	22.3	213.1	8.7	10.1
1976/77	2339.7	26.6	233.4	10.0	14.9
1977/78	2882.7	23.2	276.9	10.4	4.0
1978/79	3462.0	20.0	350.5	9.9	-4.8
1979/80	4072.1	17.6	451.1	9.0	-9.1
1980/81	4792.1	17.6	563.4	8.5	-5.6
1981/82	6063.0	26.5	705.2	8.6	1.2
1982/83	7521.0	24.0	909.2	8.3	-3.5
1983/84	8996.0	19.6	1199.5	7.5	-9.6
1984/85	10421.0	15.8	1683.4	6.2	-17.3

* At constant market price, (1970 = 100)

* Consumer price index (CPI).

Source: Economic Surveys; Bank of Sudan Annual Reports, various issues.

However, with high levels being reached in 1974 and 1977, the GDP registered low growth rate in 1978, being 4%, then successive negative growth rates. That is, the positive trend of growth rates of the GDP was reversed in the late 1970's

and early 1980's. It fell to a negative rate of 5.6% over the period 1978-1985. This could be attributed partly to the substantial fall of agricultural production in the rainfed areas and cotton production in the irrigated area. Table 5.1 shows the GDP annual growth rates for the period 1970-1985.

5.3.2 GNP per capita growth rates

With respect to GNP per capita, Sudan is classified with the low-income countries. Per capita income is low, being US\$ 200 per head in 1978, US\$ 370 in 1979, US\$ 410 in 1980 and increased to US\$ 440 in 1982; it was only US\$ 330 in 1987. However, compared with other countries in the same group, Sudan's per capita income is relatively higher, (Table 5.2).

On the other hand, the average annual growth rate of per capita income is lower than the average for the group of low-income countries as a whole. Average annual growth rates were negative since 1981 and onwards, (Table 5.2). The level of per capita income was affected negatively by the slow growth of the economy, the droughts and the inflow of refugees.

5.3.3 Distribution of GDP

As it has been mentioned above, the Sudanese economy is dependent on the agricultural sector which never constituted less than 25% of the GDP. On the other hand the contribution of industry was and is still very weak. At the same time there is a persistent unnecessary expansion of the unproductive sectors. The services sector never constituted less than 48% of the GDP over the period 1980-1987. An agricultural sector regularly accounted, on average, for 35.37% of the GDP, having declined from 57% soon after independence and 40% in 1974.

A quick look at Table 5.3 will display this heavy dependence on agriculture. While for Sudan agriculture constituted 35% of the GDP over the period 1980-1985, for middle-income economies it constituted only 3% of GDP over the same period. In being heavily dependent on agriculture, Sudan is similar to other low-income economies, (Table 5.3).

The contribution of industry remains insignificant. On the eve of independence

Table 5.2: GNP Per Capita

years	Low-income economies	Middle-income economies	Industrialised economies	Sudan
1978	200*	1250	8070	320
1960-78	(1.6)*	(3.7)	(3.7)	(0.1)
1979	230	1420	9440	370
1960-79	(1.6)	(3.8)	(4.0)	(0.6)
1980	260	1400	10320	410
1960-80	(1.2)	(3.8)	(3.6)	(-0.2)
1981	270	1500	11120	380
1960-81	(2.9)	(3.7)	(3.4)	(-0.3)
1982	280	1520	11070	440
1960-82	(3.0)	(3.6)	(3.3)	(-0.4)
1983	260	1310	11060	400
1965-83	(2.7)	(3.4)	(2.5)	(1.3)
1984	260	1250	11430	360
1965-84	(2.8)	(3.1)	(2.4)	(1.2)
1985	270	1290	11810	300
1965-85	(2.9)	(3.0)	(2.4)	(..)
1986	270	1270	12960	320
1965-86	(3.1)	(2.6)	(2.3)	(-0.2)
1987	290	1810	14430	330
1965-87	(3.1)	(2.5)	(2.3)	(-0.5)

* In US\$; * Average annual growth (percent).

Source: The World Bank, Development Reports, various issues.

in 1956, industry's share of GDP was only 4.3% and that of manufacturing a mere 7%. These shares did increase during the 1960's, with manufacturing and mining accounting for 9% of GDP by 1970, and remaining at the 6% level through the latter part of the 1970's, before increasing slightly to 8% in 1983, and 9% in 1985.

As for the services sector, it expanded and constituted a larger share of the GDP. Nevertheless its share to GDP is less than that of many other low-income

countries, although it is higher than the weighted average for these countries, (Table 5.3).

Table 5.3: Structure of Production (percent)

	Distribution of GDP			
	Agriculture	Industry	<i>Manufacturing*</i>	Services
1978	43 (38)*	12 (24)	6 (13)	45 (38)
1979	38 (34)	13 (36)	6 (13)	49 (30)
1980	38 (36)	14 (35)	6 (15)	48 (29)
1981	38 (37)	14 (32)	7 (14)	50 (31)
1982	36 (37)	14 (32)	7 (14)	50 (31)
1983	34 (37)	15 (34)	8 (14)	51 (29)
1984	33 (36)	16 (35)	.. (15)	51 (29)
1985	26 (32)	18 (33)	9 (26)	57 (35)
1986	35 (32)	15 (35)	7 (24)	50 (32)
1987	37 (31)	15 (37)	8 (..)	48 (32)

* As a subsector of the industrial sector; * Low-income economies.

Source: The World Bank Development Reports, various issues.

5.3.4 Consumer price inflation

The Sudanese economy has been suffering from accelerating inflation rates, specially since the mid-1975. An average annual rate of inflation was only 3.7% during 1960-1970; it was 15.2% between 1970-1982, and then reached 31.7% over the period 1980-1985 and 32.6% over 1980-1986, (The World Bank, World Development Reports).

IMF figures for annual consumer prices increases range between 25 and 31% for the period from 1979 to 1983. Today, unofficial estimates of inflation vary from 25% to 100% or more. The inflation has been fuelled by persistent deficit financing and by the chronic transport bottlenecks leading to a scant supply of necessary consumer goods. That is, it is mainly caused by structural rigidities. Devaluation of the Sudanese pound and the gradual removal of food subsidies in

accordance with the conditions attached to the IMF credits have also contributed to the inflationary pressures.

In contrast to other low-income countries, Sudan is characterised by higher inflation rates, (Table 5.4). Throughout the period 1978-87, the average annual rate of inflation is higher than the weighted average for the group of low-income economies. As the figures on Table 5.1 tell, the deflated consumer price index increased from 100 in 1970 (1970 = 100) to 191.8 in 1974/75, 451.1 in 1979/80, 1683.4 in 1984/85. The index reached 2290.2 in 1986 and 2903 in 1987.

Table 5.4: Inflation Growth Rates (percent)

Years	low-income economies	Sudan
1960-70	3.0	3.7
1970-78	10.6	7.4
1970-79	10.8	6.8
1970-80	11.2	15.8
1970-81	11.2	15.9
1970-82	11.5	15.2
1973-83	5.4	18
1973-84	5.9	19.3
1980-85	7.5	31.7
1980-86	8.1	32.6
1980-87	8.6	31.7

Source: The World Bank Development Reports, various issues.

Table 5.5 displays the cost of living indices in Khartoum. It is obvious, however, that these indices are high, especially for the low-income salaried groups. The Khartoum cost of living index rose from 100 in 1970 to 787.1 in 1982 for all income groups. It continued rising until it reached 2673 in 1986 for the low income groups, (Bank of Sudan, Annual Report, 1986) and 3226.3 in 1987 (Economic Survey, 1987/88). However, no one can tell what exactly is the level of inflation in Sudan. Even the official circles and those who are concerned are not certain about it.

Table 5.5: Cost of Living Indices*: Great khartoum

	low salaries index (%)	High salaries index (%)
1981	643.5	604
1982	808.2	765.2
1983	1055.9	1007.6
1984	1417.2	1317.3
1985	2060.3	1938.7

* (1970 = 100)

Source: Bank of Sudan Annual Reports, relevant years.

5.4 Economic Structure

5.4.1 Agriculture

Theoretically Sudan has great agricultural potential. The agricultural sector occupies a dominant position. Agriculture still accounts for some 35% of the Sudan GDP and around 90% of its exports, while providing the livelihood for about 80% of the population. In short agriculture will remain the key sector of the Sudanese economy for the foreseeable future. This sector is composed of four distinct activities:

(a) Modern irrigated farming, the majority of which is large scale schemes. With an area of four million feddans, these produce cotton, groundnuts, sorghum, wheat and sugar. The agricultural output of these schemes, however, largely determines an economic growth of the economy.

(b) Mechanised rainfed crop production sector with an area of about five millions, which produce sorghum and sesame.

(c) Traditional rainfed farming with an area of about nine million feddans, producing millet, sorghum, sesame, groundnuts and gum arabic.

(d) Animal husbandry or livestock subsector.

The first two subsectors together account for 65% of agricultural production. Because of the labour intensive methods of the traditional sector, however, it is equally important socially. Furthermore, while the irrigated modern agricultural sector might provide most of the country's foreign currency, it is the rainfed sector which provides the food requirements of the population at large.

However, a few years ago, the Sudan experienced severe years of drought. Indeed the lack of rainfall in 1984 was unprecedented before and this affected crop production. Cotton production, the main cash crop, has been fluctuating and in many times low world prices left large quantities of the cotton stocks unsold.

In general, crop production, especially cash crops, was not high enough since the 1970's. The 1970's witnessed a rapid rise in oil prices which accounted for a growing proportion of Sudan's imports bill. But although prices of major Sudanese export crops were rising, this favourable price trend was not utilised as the quantum index of exports was falling. However, the United States Agency for International Development (USAID) is arguing that with the cost of inputs such as fuel and insecticides rising, cotton's net profitability has come under pressure. It believes that Sudan's export potential now lies in food production in the rainfed sector. This view appears to imply a reversal from the previous United States and IMF policy of recommending that cotton production should supplant food production, (EIU Country Report, 1986/1987).

5.4.2 Industry

In terms of industrial development the Sudan is classified as a non-industrialised economy as the value added share is less than 20%. The manufacturing sector as a subsector of industry is supposed to be the most dynamic of all sectors in terms of affecting the growth process. But the role of the Sudanese manufacturing sector remains relatively small. For instance, manufacturing and mining contributed 7.9% of GDP in 1982/83, and it employed only 3.5% of the total labour force inside the country, (The World Bank, 1985).

Industry has been promoted either through processing agricultural products, or manufacturing import substitution goods. It started with the ginning of cotton early in this century. After independence, factories were concentrated in and

around Khartoum and the initiative was left to the private sector.

The 1970's witnessed a growing industry, especially the textile industry, supported by official as well as private foreign capital. The industrial sector is dominated by two activities which are typical of most of the LDCs' in their early stages of industrialisation; these are tobacco and food beverages industries and textiles, clothing and leather industries. Heavy industry is confined to two cement plants and petroleum processing in the single Port Sudan Refinery.

There are, however, a number of reasons for the negligible contribution of manufacturing sector to the GDP. It faces severe shortages of trained man-power, raw materials and foreign exchange needed for importing essential intermediate inputs. Production costs increased due to a series of devaluations of the Sudanese pound, (Mohamed, S. H., 1985). These, coupled with infrastructural bottlenecks and unannounced interruption in electricity supply, have led to a drastic fall in capacity utilisation. A study of capacity utilisation in 1977 has shown that 22 plants were operating below 65% of their capacity and 10 plants below 35% (Ministry of National Planning, 1977).

Moreover, there are delays in the implementation of new industrial projects. Manufacturing industries in the Sudan could not as yet compete with imported products – especially since they have to obtain raw materials in the parallel market.

The current emphasis is on rehabilitating existing manufacturing industries. With the help of regional and international organisations, the comprehensive rehabilitation programme aims at increasing capacity utilisation and improving the capital stock of the factories.

5.4.3 Transport

The Sudan has an extremely large land area as already mentioned. Transport is, therefore, vital for economic development. Distant consumption and production areas need an efficient network of transport and communications. Transport bottlenecks have been a serious impediment to economic growth.

Railway transport has been dominant for many years, carrying about two thirds of long distance freight transport. The operational performance of railway

has been poor and railway traffic does not exhibit any regular trend of the traffic growth for several years. The declining trend is explained on the one hand by partial traffic diversion to road transport and on the other hand by the inability of the railway to handle the freight available sufficiently quickly. This, however, is a consequence of: (a) insufficient locomotives and rolling stock; (b) lack of spare parts and physical damage to the track caused by washouts and excessive heat.

Moreover, the railway corporation faces many problems, that of transporting consumption goods at less than marginal cost prices, the empty trucks going to Port Sudan and the scarcity of liquidity to replace old machines. These factors, combined with administrative problems and frequent strikes, have caused delays, low operating speeds and locomotive breakdowns.

In view of the poor performance of railway, road transport received an increasing attention in the 1970's. By 1977, the cumulative asphalted road length had risen to 1081 k.m. and to 2000 k.m. in 1985/86. As a consequence, the contribution of road transport to the GDP increased from 2.8% in 1974/75 to 8.1% in 1982/83 and to 11% in 1985/86.

5.4.4 Power

Because of energy problems, electric power generation is an essential infrastructure – especially from water sources. 70% of the total public power supply is provided by hydro-electricity up to 1983. This heavy reliance on hydro-electric power for the country's electricity supply causes considerable problems. Despite the steady growth in electric power generation, electric power supply is still uncertain and inadequate. The problem with electric power is that the Rosseris Dam grid provides about 83% of the total electric generating capacity. This grid is dependent on the seasonal flow of the Blue Nile. During rainy season it does not work and electricity is generated by the thermal power stations. The supply cannot meet the growing demand.

Moreover, electricity consumption grew rapidly between 1970 and 1980. This is attributed to the excessive needs of irrigation schemes and the many manufacturing industries established in the 1970's. Also, there has been an increasing demand by domestic and commercial consumers in the urban areas.

5.5 Public & Private Sectors: A Contribution to Development

The initiative for undertaking capital investment in the Sudan has been shared almost equally between the public and the private sectors. This applies to experience recorded for the latter half of the 1960's, as well as in the Five year development plan for the period 1970-1975. This section discusses the contribution of both public and private sectors in the economy, with special emphasis on the latter. The periods covered are the 1960's and the 1970's till 1977, the year when the last development plan, the Six-year plan, was launched. After 1977 there were stabilisation programmes which started in 1978 and continued up to 1985. During the period 1985-1987 there were no economic development plans. In late 1987, a new four-year ESP has been launched. Throughout the entire period, all economic plans and programmes emphasised an importance of the private sector. This is vital for the sake of this study which evaluates the role of Islāmic credit in economic development, especially the role of IBs, as private sector banks. It is important because if the policy makers adopt a socialist approach in development planning, all private banks would have minor role to play. Now that from the development planning point-of-view all banks, including IBs, face no hinderance, as the government recognises and emphasizes their role as a part of the private financial institutions to finance development. It is, however, relevant to give first a brief account of the trends of consumption, savings and investments in the economy.

5.5.1 Propensity to consume, saving & capital formation

The Sudan is characterised by dualism in most aspects of economic and social activity. This economic dualism has important implications for government policies, the pattern of consumption expenditure and real investment opportunities.

5.5.1.1 Consumption

In the Sudan, as a LDC, the marginal propensity to consume, MPC, and the average propensity to consume, APC, are influenced by the relatively large traditional sector and demonstration effects. Therefore they tend to be high.

Over the period 1955-1967, the share of consumer spending in disposable income remained within a range of 89.8 to 98.4%. The data for the entire period

reflect an average propensity to consume for the Sudanese economy of 93%. The MPC was 0.89, (Lees F. A. & Brooks H. C., 1977). The average annual growth rate of private consumption increased from 1.7% over the period 1965-1973 to 7.3% during the period 1973-1983. The average for all the low income economies was 3.5% and 4.5% for the two periods respectively, (The World Bank, Development Report, 1985). As a percentage of GDP, the average for consumption for the period 1970-1979 was 89.4%. Thus, it is generally noticed that the Sudanese economy is characterised by higher levels of MPC. This characteristic is also clear from the structure of consumption. 65% of total households consumption is for food and clothing and footwear, (The World Bank Development Report, 1989).

5.5.1.2 Savings & capital formation

With regard to capital formation in the Sudan, the main economic problem has been and still its excessive dependence on the cultivation and export of a few agricultural products. Lack of adequate savings has prompted a recourse to external sources of investment funds. It further required government fiscal policy to be directed to financing a major share of the accumulation of capital. Throughout the periods 1960-1970 and 1970-1978, fixed capital formation has represented a modest 11.13% and 13.13% of GDP for the two periods respectively, (U.N., Year Book of National Accounts Statistics, 1984). Table 5.6 shows the formation of fixed capital up to 1978, as there are no data for recent years.

Table 5.6: Total Gross Capital Formation

	Gross capital formation(LS. million)	GDP (LS. million)	As a percentage of GDP
1970	89.6	761.1	11.8
1974	265	1510.8	17.5
1975	427.5	1848	23.1
1976	399.6	2339.7	17.1
1977	413.7	2882.7	14.4
1978	431.5	3253.8	13.3

Source: U.N., National Accounts Statistics, 1984.

Several reasons are accounted for the low ratio of capital formation. These include, (1) the low level of per capita income which reduces opportunities for savings, (2) the absence of a large competitive business enterprise sector to initiate highly profitable investments, (3) the scarcity of infrastructure and (4) limits on the ability of the economy to attract foreign sources of capital in large amounts. The last two factors are more effective especially since the beginning 1980 when the economic position deteriorated and the flow of capital from the Arab oil-producing countries was reduced sharply.

5.5.2 Public & private sectors' role

In order to trace the contribution of each sector, and in particular the private enterprise role, this is done by subdividing periods since 1956 – the year of political independence of Sudan.

(I) The period 1956-1960

In the Sudan, although the government financed a major share, the private sector played a vital role in economic development. This is noticed either through its contribution in total investment and financing, in providing labour opportunities or in the value added. Over the period 1955/56-1960/61, fixed investments were distributed between the public and the private sector as 60.5% financed by the former and 39.5% by the latter.

(II) The periods 1960-1970 & 1970-1975

The Ten-year plan assigned 60% of total investment to the public sector and the remaining 40% to the private sector. Although there was no accurate information on the actual investments undertaken by each sector, the studies preceded the revised Five-year plan pointed out that, the public sector financed 52% and the private sector 48% of the actual investment during the period 1965-1970, (Ministry of National Planning, 1977). In particular, over the period 1968-1972, the private sector's contribution was major. It financed 58% of the total investment.

Estimates of the Five-year plan allocated 55.8% of investment to the public sector and 44.2% to the private sector. All these figures indicate that the private sector is growing side by side with the public sector. However, had it been provided

with formidable climate for investment, the private sector could contribute more. It is in fact true that the private sector occupied a dominant position over years, but the major share of its investment went to housing, and, to a lesser extent, to transport. 51% of private investments in the Five-year plan was basically in housing. Even in the Ten-year Plan, it was not less than 30% of the total private investment.

(III) The Six-year Plan 1977-1983

The Six-year plan started in 1977 to cover the period 1977-1983, but only after two years the plan was discontinued and since 1978 the government has adopted stabilisation and reformation programmes. Even then, the salient feature of the plan was its explicit recognition of the decisive role of private sector and its ability to achieve a high level of investment. Investment estimates of the plan were LS. 2670 millions, LS. 1570 millions would be from the public sector, and LS. 1100 millions were assigned to be financed by the private sector.

The plan was formulated with a view to greater contribution from private finance, both internal and external. A cornerstone of the plan was the incentives declared to increase private investment. It was stated that local financing would be solved by an extension of banking services so that commercial banks would extend credit facilities, and for external financing, planners determined the investment priorities which needed financing.

In the Six-year Plan concentration on agriculture was big. As compared with the Five-year plan, the Six-year Plan allocated 26.4% of private investment into agriculture, while the former plan directed only 16% of private investment to agriculture. Although the plan included ambitious development objectives it was discontinued. Since 1978 the Sudanese economy geared to adopt the IMF policies.

There have been three-year stabilisation programmes. With more submission to the IMF prescribed measures, the structure of investment changed with an attempt to increase private investment. A number of public enterprises were liquidated and reorganised to allow private shareholding. The government continued following the system of three-year programmes. These programmes were revised annually. Up to 1985, there were six 'three-year' public investment programmes.

These programmes stated only investment for the public sector and the private investment was not included explicitly. The economic performance deteriorated and implementation of the policy was hampered by scarcity of finance and drought.

(IV) The Period 1985-1987

When the transitional government came to power in 1985, it suspended the previous three-year programmes. Instead it launched its one-year development expenditure budget for 1985-1986. The present elected government embarked on a four-year ESP which started in late 1987. The government has initiated a new extended role for the private sector, (see Chapter VIII, section 8.5).

5.6 The External Sector & Foreign Exchange Constraints

The main features of the external financial performance of the Sudanese economy are in the balance of payments' statements. The balance of payments exhibited a number of structural rigidities. Since the first half of the 1970's, there has been a persistent deficit in the current account; disbursements from external loans and other capital inflows have been insufficient to compensate for these deficits. There was a severe drain on the foreign exchange reserves of the country.

As foreign reserves ran out and the internal gap widened, arrears in external payments were accumulated, and, consequently, reschedulings were undertaken in 1980. this situation led to a severe lack of foreign exchange, causing widespread scarcities of spare parts and other vital imports needed such as capital and consumer goods. However, the main causes of this unfavourable balance of payments situation were:

- (i) weak export performance
- (ii) imports growth
- (iii) the external shocks
- (iv) a sharp increase in the external debt service burden and,
- (v) poor policies represented by persistent devaluation of the Sudanese pound.

These and other factors caused the external gap which impeded growth of the economy as a whole. However, this section discusses implications of the first four factors. The last factor's implications are elaborated in the next section which is on the the IMF conditionality applied on the Sudanese economy.

5.6.1 Export performance

The export performance in volume terms constituted the primary cause of the balance of payments' deteriorations. In the Sudan these deteriorations began since early 1970s. Poor performance of the export sector is reflected by its fluctuating and declining trend since 1974. Annual growth rates of exports began to fluctuate up and down up to 1978 when the annual growth rate was negative (-12%).

In volume terms exports declined but increased in nominal terms both because of the devaluation of the Sudanese pound and increases in prices. This is why exports showed an increasing growth rate between 1978 and 1983. After 1983 and up to the mid-1987, exports exhibited slow growth rates which were -1.4% and -0.7% in 1986 and 1987 respectively. These rates of growth which pertain to total exports proceeds hide the actual decline in the volume of the most important Sudanese exportable crop, cotton.

Cotton exports ratio declined from 55.4% in 1973 to 35.5% in 1974. They then fluctuated and reached their lowest level in 1981, as cotton exports constituted only 19.2% of total exports. The sharp fall could be attributed mainly to : (a) the unfavourable weather conditions which affected both sowing and picking of the crop, (b) the various cotton diseases and (c) shortages of labour for picking. Cotton exports represented 44% and 30.4% of the total Sudanese exports in 1986 and 1987 respectively, (Economic Survey, 1987/88).

However, this poor performance of exports led to a deteriorated balance of payments. On average, the annual growth rate of exports was 10% and 18% for the two sub-periods 1973-1978 and 1979-1987. Over the same sub-periods, the average annual rate of growth of imports were 27% and 19% respectively. Therefore trade balance deteriorated over time. In 1983, the trade deficit became LS. 1318.9 million and reached LS. 1569 million in 1986.

5.6.2 Imports growth

A rapid growth rate of imports caused LDCs in general to be in a continuous balance of payments deficit. In the case of the Sudanese economy, imports' average growth rate was 27% over the period 1973-1978 and 19% since then up to the first half of 1987. This rapid growth rate resulted mainly from the increase in the quantity and value of imports. The bulk of Sudan's imports is composed of foods, manufactured goods, transport and machinery equipment, in addition to petroleum products. The value of these items, which are necessary, represented about 80% of the Sudan total imports. Moreover, an increase in the value of imports was associated also with the adjustment in the exchange rate of the Sudanese pound frequently since 1978.

With negative growth of exports and a rapidly growth rate of imports, the government attempted to control the cumulatively worsening position of the balance of payments. It applied the IMF measures which aimed at raising domestic prices of the exportable products and giving incentives to producers to increase supply. They aimed also at restoring the profitability of government entities engaged in export activities.

But numerous rigidities in the Sudanese economy, together with the highly inelastic nature of the supply of agricultural produce which dominates Sudan's exports, mitigated against an immediate or medium-term increase in exports.

The measures applied were, as well, expected to reduce imports, but the demand for imports of consumer and producer goods is highly inelastic. Therefore the overall impact of the government efforts to reduce the balance of payments deficits was negative. Imports' prices increased, exports' prices increased but to a lesser extent. One study shows that after devaluation of the Sudanese pound in 1978, imports' prices grew by 27% while those of exports grew by 16% only, (Hussien, M. N., 1985).

The worsening balance of payments created an external imbalance which has been impeding economic growth. The situation was getting more severe by an internal gap – the sharp difference between government expenditure and revenue. Both external and internal gaps reinforced the need for external and domestic

borrowing. As a result, deficit financing increased tremendously. For instance, changes in money supply increased from LS. 181.5 millions in 1979/80 to LS. 1447 millions in 1984/85 and LS. 3624 million in 1987. The central government's net position with the banking system deteriorated by LS. 58.8 millions in 1979/1980 and jumped to LS. 1899.7 millions in 1985/86. Government's indebtedness abroad is nearly U.S.\$ 13 billions. The economy is facing a sharp rise in debt service costs.

5.6.3 An external shocks & terms of trade

The Sudan's balance of payments and trade balance were affected by the kinds of external shocks as well. These shocks were attributed to the cyclical movements in the world markets:

(a) First, there was a four-fold increase in the price of oil in 1973/1974 and the successive increases afterward, especially in 1980. These increases had direct effects through a rising import bills and an indirect effects through inflationary pressures imported with manufactured goods.

(b) Second, the slow-down in the industrial economies led to a reduction in the demand for all LDCs' exporting primary products. Therefore the economic growth and foreign exchange earnings of the Sudan were adversely affected by slack markets, because the economy depended heavily on production and exportation of primary products.

(c) Third, the implementation of stabilisation policies by the industrialised economies caused a sharp rise in nominal and real interest rates in the world markets. Terms of borrowing became harder and debt service costs rose sharply.

However, a rise in oil prices had compound effects in the Sudan as it increased costs of essential input materials such as fertilisers, pesticides and gasoline which are used in pump irrigation schemes. Cotton, the major export crop, is also import-intensive. It was estimated that 20% of gross earnings from cotton exports were used to meet the spraying costs for pest control, (Ministry of Finance, 1981).

Therefore, external shocks caused a sharp rise in import prices, particularly the oil bill. These shocks resulted in a deterioration in the terms of trade which registered an annual rate of decline of 0.2% between 1975/76 and 1978/79 and a

further decline of 0.7% between 1981/82 and 1984/85. Table 5.7 shows growth in the terms of trade¹⁶ of the Sudanese economy.

Table 5.7: Growth of Merchandise Trade & Terms of Trade

Years	Exports (LS. million)	Imports (LS. million)	Resource balance	Terms of trade
1977/78	691.1	1360.0	(663.9)*	92 (1970 = 100)
1978/79	699.4	1321.3	(621.8)	78 (1975 = 100)
1979/80	798.4	1563.5	(765.1)	86 (1975 = 100)
1980/81	698.9	1850.4	(1151.5)	88 (1975 = 100)
1981/82	704.2	2166.7	(1461.5)	87 (1980 = 100)
1982/83	839	2042.5	(1203.5)	88 (1980 = 100)
1983/84	732	1417	(685)	96 (1980 = 100)
1984/85	374	771	(397)	87 (1980 = 100)
1985/86	497	1138	(641)	70 (1980 = 100)
1986/87	482	694	(212)	84 (1980 = 100)

* Brackets indicate deficit.

Source: The World Bank, Development Reports, various issues.

What all these imply is that the external imbalance widened. Foreign reserves were depleted and the government resorted to borrow externally at the world market competitive prices.

5.6.4 An external debt service burden

An internal imbalance, together with sharp rises in import prices exacerbated the country's long standing balance of payment's difficulties. These factors led to a sharp rise in foreign liabilities and a precarious official reserve position.

The government, in order to finance the deficit, has increased its external borrowing sharply and most of the large loans acquired have relatively short maturities

¹⁶ The terms of trade, or the net barter of trade, measure the relative movement of export prices against that of import prices. Calculated as the ratio of a country's index of average export prices to its average import price index, this indicator shows changes over a base year in the level of export prices as a percentage of import prices.

and high interest rates. In addition, there has been a remarkable increase in the banking system's indebtedness which consisted mainly of short term credit. In consequence, the Sudan's total external debts have increased.

With a sharp rise in their amounts, the cost of servicing debts rose to high levels. Sudan's debt servicing ratio rose from 15% in 1978 to 25% in 1980 and 40% in 1981 despite the rounds of rescheduling with the Paris Club between 1978 and 1982, (IBRD Report, 1982).

The Sudan's debt problem was, however, aggravated by an unfavourable debt structure. For instance of the U.S.\$ 2.4 billions contracted debt before 1978, 68% was on hard terms with an average rate of interest of 7.1% and an average maturity of 9.7 years (including the three year grace period), and with a grant element of only 11%, (IBRD Report, 1978). Therefore the external sector performance had been hardly affected by an increase in the cost of servicing debts which are mounting over time.

Due to the debt problem, successive governments, including the present one, were and still, trying to follow economic policies geared to repayment of debts and, more or less, designed by creditors. Table 5.8 shows the changes in external public debt and debt service ratio for the period 1977-1985.

5.7 The Sudanese economy & The IMF

As the impact of the IMF policies on the Sudanese economy has been considerable, it is worth examining the effect in detail, especially as other Third World debtors are in similar position. Sudan has become one of the most troubled debtors with high debt servicing ratios and severe balance of payments difficulties. This section discusses the various economic crises in the Sudan and the devaluation policy used to solve these crises.

The devaluation policy is the IMF's proposal which is known as the "supply side framework for exchange rate determination", (Nashashibi, K., 1980). The approach of the IMF is to use the exchange rate not as an instrument for increasing the demand for a country's tradeable goods, but to increase the profitability of supply. This is to improve the competitiveness of each export by relating its

domestic costs to its international value added. The international value added is the difference between the value of output and the value of imported inputs used in production, both measured in domestic currency.

Table 5.8: External Public Debt & Debt Service Ratios

Years	Debt size* (\$ million)	Interest payments (\$ million)	Debt service as a percentage of	
			GNP	Exports
1978	2076	36	1.4	9.4
1979	2114	86	4.5	33
1980	3097	16	1.8	14.4
1981	4807	31	1.0	5
1982	5093	11	0.8	7.5
1983	5726	37	1.2	11.2
1984	5659	65	..	13.6
1985	5086	67	1.8	15.6
1986	7057	32	0.8	7.7
1987	7876	18	0.6	6.8

★ Excluding the use of IMF credits and short-term debts.

Source: The World Bank, Development Reports, various issues.

Many economists view devaluation as advantageous, easier and quicker than demand management alone in solving balance of payments problems. The use of devaluation as a solution or means of solution should be preceded by a prior study and recognition to the import and export elasticities.

Devaluation is regarded as successful and effective if imports of the country are mainly luxurious goods with a high price elasticity. The rising prices of imports are to be traced by lower quantity demanded without affecting the level of satisfaction of consumers significantly. Also exports are to be highly responsive to price changes. That is, the demand of external consumers to Sudanese exports should be price elastic, as devaluation makes exported products relatively cheap and then the demand for exportables would be expected to increase. If, however, these primary conditions and pre-requisites are satisfied, the devaluation would be regarded as the best quick tool to improve the balance of payments.

5.7.1 The IMF argument for devaluation

The IMF argued that domestic and international economic developments, affecting budettary operations, credit expansion and cost price relationship, have resulted in structural disequilibria in the Sudanese economy, and imbalances in both the budget and balance of payments. Devaluation of the Sudanese pound is seen as a corrective action.

The principal aim is to accelerate growth by efficient utilisation of the country's potential resources especially in agriculture and agro-industries. A mix of fiscal and monetary policies is used to raise the rate of savings to meet the increasing development and expenditures. Therefore the devaluation would accord the proper valuation to imported foodstuff, raw materials and capital goods. Hence, the basis for investment profitability and its sectoral distribution would be set. The devaluation will provide incentives to producers to increase productivity since the domestic export prices are raised. The taxable base and tax yield will expand, (IMF, Sudan: Memorandum on Exchange Rate and Related Measures, Undated Note).

Reliance on foreign borrowing by public entities and credit expansion are to be adjusted. The credit expansion by commercial banks in support of the private sector also needs to be controlled. The IMF went ahead in detailing the impacts of the proposed programme on different aspects of the economy:

(I) Internal imbalance

An increase in investment outlays in the economy has not been matched by an increase in savings. This is mainly because of extravagant spending. In addition, public entities have been incurring losses, and their financial position deteriorated. Both the deficit financing and reliance on external loans increased remarkably.

Borrowing raised the country's indebtedness abroad which is too difficult to be sustained by the current available receipts. Moreover, the above factors led to a sharp rise in domestic prices exceeding the price inflation experienced by the Sudan's main trading partners. Labour costs rose as a consequence.

(II) External imbalance

In addition to the government's direct expenditures on imports for development, the build-up of inflationary pressures and the undervaluation of import prices increased the importation of consumption items and raw materials while at the same time reducing supply availabilities for exports.

Balance of payments deficits rose over time. Therefore, the IMF recommended that urgent steps should be taken to reduce inflation and restore viability to the balance of payments in the medium term, otherwise it would be difficult for the country to acquire further external loans and development programmes will be jeopardised.

(III) The exchange rate adjustment

The IMF argued that the strengthening of the United States dollar which started in the early 1975, made it important to review the exchange rate of the Sudanese pound.

In the six months ended September 1975, the value of the Sudanese pound as measured by the trade weighted effective exchange rate had appreciated by about 10%. The IMF maintained that calculations based on restoring profitability of production for exports would suggest a depreciation of the Sudanese pound to about LS. = US.\$ 2.00. This rate would entail a 30% reduction of the official rate of LS. = U.S.\$ 2.872 and a 20% reduction of the official rate of LS. = US.\$ 2.50. This rate, it was argued, should be adequate to realign the Sudan's cost structure with international prices. Thus it would assure the competitiveness of the Sudan's major crops (cotton, sorghum, groundnuts, sesame and sugar), and generate substantial opportunities for the expansion of agro-industries, thereby expanding export capability.

However, for the devaluation to bear its full impact on the allocation of resources, it is necessary to allow the price mechanism to adequately reflect costs of production. In particular, a land and water charge imposed on all crops grown in the Gazera scheme should be substituted for the present cost sharing adopted for cotton production. Moreover, these measures depend largely on the restoration of domestic monetary equilibrium.

(IV) Impact on the balance of payments

In the short-run, the devaluation would result in moderate improvement in the trade balance and it will be greater overtime. As the cropping pattern is adjusted, new land is brought under cultivation, and the Sudan moves into the production of elastic demanded products. Devaluation would help in relaxing import qualitative restrictions and allows for imports to be largely determined by market forces; hence an efficient use of the country's scarce foreign exchange resources would be the result. Production of import substitutes would be stimulated and would also encourage foreign investments.

(V) Stabilisation and budgettary impact

The IMF Note analysed the stabilisation and budettary impact of devaluation. The first objectives of stabilisation programme taken in conjunction with a devaluation will be to improve the financial position of the government and the public entities in order to reduce sharply the rate of domestic credit expansion. To improve the government's financial position it will be necessary to:

- (1) Curb the rise in current expenditures at all levels;
- (2) Limit the local governments' reliance on budgettary transfers from the central government;
- (3) Raise taxes and certain prices charged by the public sector enterprises;
- (4) Keep the development budget expenditures to a level that can be financed from a non-inflationary domestic sources and external loans on favourable terms;
- (5) Finally, the Bank of Sudan must control credit expansion. An improvement in the government's financial position requires additional tax measures.

The IMF Note included also a comment on the impact of devaluation on the cost of living. It recommended an increase in domestic prices of wheat and sugar. Devaluation was expected to reduce profit margins of importers, and increase domestic production of import substitutes.

5.7.2 A Sudanese counterargument

At the time when the IMF prepared its note, a group of Sudanese economists

argued against it, (El Hassan, A. M., 1977). The counterargument stated that:

(a.) Devaluation as a measure to bring about improvement in the balance of payments gives the best results when the demand for exports and imports is highly responsive to price changes as measured by the price elasticity of demand. The resulting improvement in the balance of trade from a given devaluation would be more pronounced the higher the price elasticities of demand for both imports and exports. A worsening of the balance of trade would occur following a devaluation if the absolute value of the sum of the price elasticities of imports and exports is less than unity.

Despite the importance of checking the elasticity magnitudes, the IMF did not make any attempt to see the values of the elasticities in question. This is so because computation of Sudan's exports and imports price elasticities of demand indicates that:

The cotton export elasticity and that of oil seeds are -0.47379 and -2.38585 respectively. The resulting weighted exports price elasticity is -0.75070. As for imports, calculations reveal that the import elasticity for consumer goods is extremely low, -0.11258. Thus the argument for the devaluation of the Sudanese pound no longer stands.

Even if the elasticity criterion for exports is satisfied, the next thing to consider is the supply response of the economy to the devaluation measure. The IMF tends to assume that subsequent to devaluation the economy will almost immediately react by increasing the supply of the export products. But the numerous rigidities that characterise the Sudanese economy, together with the highly inelastic nature of the supply of agricultural produce which dominates Sudan's exports, mitigate against an immediate or even a medium term increase in exports, (Ali, A. A. G., 1985).

Besides, the demand for imports is likely to be inelastic in the short run as imports have already been reduced to essentials by quantitative restrictions. Moreover, since Sudan's import policy is centrally controlled, any reduction in imports which the devaluation is supposed to bring about can be equally or better achieved by administrative decisions.



Devaluation will increase the budgetary cost of development expenditures substantially because of the large import content of such expenditure.

It is held that the proposed devaluation would result in an improvement in the financial position of some of the Sudan's commercial entities (i.e. revenues of the Sudan Cotton Board). This improvement would be negligible because of the induced inflation which will come after devaluation.

The price increase of the major imported commodities which the IMF assumes will result from the depreciation measures are likely to be even higher. This is because of the various rigidities and the low supply response characterising the Sudanese economy.

The IMF proposals assume that for the lower income groups the import content of expenditure amounts to little so that the increase in the cost of living from the devaluation would affect mainly the urban population, particularly the high income groups. This is indeed incorrect because most of the import items subjected to depreciated exchange rates are in the consumption basket of the low income group. Moreover, inflation by its nature is not selective and cannot be controlled and directed to particular groups.

5.7.3 An alternative

As an alternative to the IMF measures the same group of economists argue along the following lines:

First, the Sudanese economy, despite the distortion that characterise it, is not suffering from a fundamental disequilibrium. The core of the problem is generally, (1) the need to restore monetary equilibrium, (2) the need to rationalise government expenditure, (3) the need to curb domestic inflation.

Second, the IMF stated that cotton has been disproportionately taxed in relation to other crops, creating disincentives for producers to grow it and explaining to a large extent the stagnation in yields. This is true but the solution is not, however, devaluation. There is a case for reviewing the taxes on cotton with the aim of reducing their burden on the producer. In particular, the dual exchange rate treatment of exports and the export duty on cotton should be abolished. The

resulting increase in the tenant's income would reduce resort to practices such as freezing and liquidation of tenants' debts, production incentives, — etc.

Third, as for the need to curtail government current expenditure, the alternative is to make a downward adjustment of wages and salaries in the public corporations. In addition, the government can manipulate import duty rates so that they can be selective and applied to only a proportion of commodities. There is also a need for rationalising central/local governments financial relations with the aim of reducing central government's budgetary transfers to local governments. As far as development expenditure is concerned, the rate at which new development projects are contracted and executed is far greater than the economy can absorb. There is, therefore, a case for keeping the development budget expenditure at levels that can be financed from inflationary sources and better external soft loans.

5.7.4 An ill-concerned exchange rate policy

The IMF introduced its argument to the Sudan Government. After then the Ministry of Finance announced new financial and exchange control measures in June 1978. At the heart of the new measures adopted by the IMF lies the relaxation of the foreign exchange regulations.

The exchange rate was adjusted so that one Sudanese pound would equal to US\$ 2.5 instead of US\$ 2.8715. In other words, the adjustment in the official rate is approximately 15%. It was also decided to impose a subsidy of LS. 0.10 per dollar for all remittances except those for cotton exports and a tax of LS. 0.10 per dollar for all payments.

Prior to this devaluation there were four exchange rates for the Sudanese pound viz:

(1) The official rate, equivalent to US\$ 2.8715 per LS. or approximately LS. 0.35/US\$. This rate was applied to cotton exports.

(2) The effective rate, equivalent to US\$ 2.5 per LS. or approximately LS. 0.4/US\$. This rate was applied to all banking transactions except cotton.

(3) The incentive rate for Sudanese Nationals Working Abroad (SNWA) equivalent to LS. 0.57/US\$.

(4) The exchange rate for nil-value imports which ranged between LS. 0.6/US\$ to LS. 0.65/US\$.

The resulting post-devaluation exchange regime was still a multiple exchange rate system. The IMF was unhappy with this system and as such a new and exchange liberalisation policy package was announced on September 1979. Accordingly the new measures include the following:

i. A unification of the official exchange rate by removing the exchange-tax/subsidy scheme.

ii. Abolishing the SNWA remittance exchange rate.

iii. Establishment of a dual exchange rate system such that the official rate is to be used for a specific list of exports, imports and remittances while an incentive rate – to be determined in accordance with market signals – is to be used for exports, imports and remittances not specified in the aforementioned list.

iv. Foreign currency purchase from or sale to licensed banks and on the basis of realistic and flexible prices is authorised. The rate of exchange determined for these dealings is LS. 0.8/US\$.

Thus as far as foreign exchange is concerned, the Sudan, on the basis of this package, was to operate a dual rate system with an official rate of LS. 0.5/US\$ and a parallel rate of LS. 0.8/US\$.

After applying this dual exchange rate regime, trade was liberalised and a new economic programme was announced in November 1981 which included further economic measures. As for the exchange rate, it was declared the unification of the exchange rate for the Sudanese pound such that the then new rate was LS. 0.90/US\$. Thus, the Sudanese pound was devalued for the third time within three years.

On 15th November 1982 a new exchange rate was declared for the Sudanese pound such that US\$ = LS. 1.30. This was, however, the fourth devaluation of

the pound in a span of four and a half year. The last devaluation was executed in late 1987 when the official rate was changed so that US\$ = LS. 4.00, that is a devaluation of 80% from US\$ = LS. 2.50. The latest devaluation has been in 1989, so that US\$ = LS. 12.5.

5.7.5 A critique

Over the period 1978-1982, the objectives of the repeated devaluations revolved consistently around restoring the profitability and competitiveness of the Sudan's major export crops.

No attempt was made to indicate the period over which such an objective could be attained nor was there any attempt to indicate whether there existed an optional exchange rate for the Sudanese pound, the achievement of which could possibly be said to solve the problem of macro-economic management.

The IMF goal of achieving the ideal of a unified exchange rate for the Sudanese pound proved to be an illusion. Instead, after applying IMF proposals, this resulted in a much more complicated multiple exchange rate system with at least three exchange rates prevailing at one time. It helped the growing (black market) informal sector of dealers in foreign exchange. In the mid-1989, those street dealers in foreign currencies sold one dollar for twenty Sudanese pounds.

5.8 The Economic Performance After Implementing IMF Policy

The broad lines of the Fund's policy are, (1) cuts in government expenditure, both current and developmental; (2) a reduction of deficit financing; (3) limiting growth of the money supply; (4) abolition of trade controls and prices; (5) elimination of subsidies; (6) removal of export and import monopolies; (7) devaluation of the pound to its realistic levels; (8) liberalisation of the foreign exchange and reduction in government trading activities. According to the IMF, if all these policies are implemented, they would result in both internal and external balance.

Unfortunately, none of these is realised in the Sudan. Cash crops production deteriorated sharply after implementation of the IMF programme, while imports increased tremendously and the trade deficit widened,(see Table 5.6).

Devaluation policy failed as well in accelerating capital inflows. Remittances by the SNWA were reduced on expectation of a series of devaluation. Capital fled outside the country.

Inflation rates in the Sudan are now amongst the world's highest. In 1975-1976 the inflation rate was only 3.5% per year, one of the lowest in the developing world, (see the table on consumer price inflation). Internal deficit financing was growing over time. The public sector's overall deficit increased from LS. 139.3 million in 1977/1978 to LS. 179.3 million in 1978/1979 and accelerated to LS. 639 million in 1981/1982, (Bank of Sudan Annual Reports). The position of the public entities, which was expected to improve, deteriorated further. Their financial position with the Bank of Sudan declined from a deficit of LS. 42.7 million in 1979/1980 to LS. 131.5 million in 1980/1981. Moreover, spending on economic services declined and debt service payments increased, which had an adverse impact on the economic growth.

The consequences of adopting the IMF policies can therefore be summarised as :

- (1) Increasing cost of living.
- (2) Redistribution of income from the poors to the rich groups.
- (3) Increased capital flight and encouragement of risk averse investment
- (4) Incentives to deal in luxurious consumption goods at the expense of necessary commodities.

Instead of having a stimulating effect on exports and import substitution, devaluation reinforced inflationary pressures and increased costs of production. Cotton which is heavily dependent on imported inputs, was most affected. In addition, industrial production was affected by devaluation as it depends on imported inputs.

The problem of the Sudanese economy needs more than concentrating on short term and price signal solution. Both the public and private sectors need to be promoted, efficiency of the public enterprises improved, and bottlenecks eliminated.

Chapter VI

Financial Intermediaries In The Sudan

6.1 Introduction

This chapter is concerned with the financial intermediaries in the Sudan in general and the banking system in particular. At the outset is a theoretical background for monetisation. The chapter then shows the financial development of the economy in a historical perspective with reference to the Central Bank of Sudan, the commercial banks and the specialised development banks. As far as the Central Bank is concerned, the chapter discusses basically the monetary and credit policies followed by the Bank of Sudan, and for commercial banks it discusses their role in the mobilisation and allocation of financial resources. Section 6.8 deals with the informal monetary sector in rural areas whose existence might be regarded as a symptom of 'financial repression'. The section discusses the factors affecting the cost of lending in rural areas in general.

6.2 Atheoretical Basis for Monetisation

6.2.1 The concept of monetisation

The term monetisation is subject to a variety of usages. It refers to

'the rate of use of money', (Sengupta, J. K., 1957, p. 19). This definition would make it identical to the concept of velocity of circulation. Sometimes a distinction is made between monetisation in the sense of using an object as a currency and monetisation meaning the evolution of monetary structures, with a further subdivision between internal monetisation (i.e. in a closed economy) and external monetisation involving the evolution of the external monetary relations of an economy. Monetisation is regarded also as a 'hinge concept' in that it analyses monetary structures, that is the transaction from barter to fiduciary currency, credit and financial intermediation.

Monetisation is different from commercialisation as it denotes the enlargement of the sphere of use of money but there are no necessary implications about specific uses of the money or specific consequences of monetisation, (Neale, Walter, 1971). Commercialisation indicates the pervasiveness of the behavioural assumption of profit maximisation, regardless of the degree of monetisation of either inputs or outputs. For any operation to be largely commercialised, the bulk of the output must be on the market. However, it is this dependence on the market rather than interest in the market that is a distinguishing feature of commercialisation, (Neale, Walter, 1971). Consequently, monetisation (measured by the proportion of the aggregate value of goods to services that is paid for in money by the purchaser) is a necessary but not a sufficient condition of commercialisation which is measured by the proportion of production sold to total production.

Monetisation is also made distinct from financial intermediation, which is defined as the process of mediation through institutions and instruments between primary savers and ultimate borrowers and is measured, for instance, by the financial interrelation ratios. This ratio is obtained by dividing the total value of tangible assets plus net foreign balance by national wealth. Financial intermediation implies financial deepening rather than widening (enlargement of the money exchange economy) which is the phenomenon expressed in the term monetisation.

To conclude, monetisation, commercialisation and financial intermediation, while distinct phenomenon, can also be interdependent and correlated in a developing economy. Still it is important to identify those indicators of monetisation which measure the 'widening' of the monetary economy, through the substitution of monetised for non-monetised transactions, as distinct from its 'deepening' which would only indicate the increase of economic activity in the already monetised sector.¹⁷

6.2.2 Monetisation and interest rates

The share of credit transactions in kind is an important indicator of the extent of monetisation. In such transactions, which are characteristics of the informal credit sectors in the less developed countries (LDCs), the principal and interest

¹⁷ For the problems of measuring monetisation see Chandavakar, Anand G., "Monetisation Of Developing Economies", *IMF Staff Papers*, vol. 24, 1977, pp. 665-722.

are all repaid in commodities such as food grains or oil seeds. Quite often, loans are made by money lenders in cash but the repayments are in kind at a stipulated price which is usually well below the market price of the commodity. Hence, the lending and borrowing mechanism in the informal credit sector which is less monetised involves payments of high interest rates, and monetisation is understood to reduce interest rates. Goldsmith mentions that

'while empirically a negative association exists in the intercountry comparison between the monetisation ratio and the interest rate level, one could not claim that the former depends on the level of the latter. The causal relationship rather runs in the opposite direction, the process of monetisation tending to decrease the level of interest rates as a capital market develops', (Goldsmith, Raymond W., 1969, p. 93).

This viewpoint was rejected, however, on the ground that the relationship between monetisation and interest rates is difficult to test because of the lack of any clearly defined channels of transmission between them. It has been argued that monetisation by itself has no direct bearing on interest rates. The more significant causal relationship would seem to be between the degree of financial intermediation and the level of interest rates. It is the process of financial intermediation rather than monetisation that will lower interest rates by broadening the capital market (Chandavakar, Anand G., 1977).

Therefore countries with high monetisation ratios are regarded as those with highly developed capital markets and, consequently, low interest rates. The relationship would seem to lie between high saving ratios and broad and active capital markets, on the one hand, and the level of interest rates on the other hand. The different components of interest rates in the LDCs, namely, the unit opportunity cost of lending money, the unit costs of administering loans, the unit risk premium and the unit monopoly profits of money lending are not directly affected by the monetisation factor. However, the prevalence of loans in kind no doubt raises the effective cost of credit to the borrower. But this is not because of the repayments in kinds, per se. Rather, it is the combination of money lending and trading that enables the lender to appropriate monopolistic profits.

6.2.3 Implications of monetisation for monetary policy

Broadly, the following variables are relevant for determining the optimal rate of monetary expansion consistent with relative price stability: (i) the rate of increase in the monetised GDP, (ii) the growth of population, (iii) the rate of monetisation and (iv) the demand for larger cash balances, with rising per capita incomes resulting from (i) and (ii).

Taking monetisation, this variable can affect money supply and velocity through (i) the transaction motive and (ii) the precautionary and speculative motives (the asset motive) leading to an increase in the corresponding type of cash balances. The replacement of payments in kind by wages, rent, interest and taxes would clearly lead to an increase in the transaction balances. Likewise, there will be an increase in cash balances owing to the replacement of savings in kind by monetary savings.

Aghevli attempted to study the effects of monetisation on the demand for money by using the number of banks as a proxy for monetisation, (Aghevli, Bijan B., 1973,). But this could be criticised as not a suitable proxy, because the number of banks has no empirical relationship to the rate of absorption of the subsistence sector into the monetary sector. It is basically a measure of institutional banking development.

However, monetisation would be a significant determinant of the demand for money in economies that still have a substantial subsistence sector and are therefore likely to undergo further monetisation. The future trend of monetisation in the LDCs would depend on the net outcome of opposing tendencies in the main components of non-monetary income. Thus, in the absence of countervailing official policies, the consumption of home-produced goods in agriculture, with sharecropping would decline and would accelerate monetisation.

The effect of monetisation on the portfolio behaviour of households and financial institutions would be governed by its effects on the distribution as well as the composition of monetary aggregates. But it is difficult to determine the quantitative distribution of the increase in the money supply as a result of monetisation between different sectors and financial intermediaries.

Some qualitative judgement can be made regarding the impact of monetisation on the composition of monetary aggregates. Thus, given the high ratio of currency to money supply in most LDCs, the inadequacy of banking facilities and the backwardness of the banking habit, the short-run impact of monetisation on the composition of money supply is more likely to be an increase in the demand for currency rather than increased bank deposits. This is so because the transition from transactions in kind to transactions in currency is institutionally easier than that from barter to bank money which involves a big jump in institutional and behavioural patterns.

Since savings banks tend to be more widespread in rural areas than are commercial banks, the choice of assets would in most cases not be between currency and demand deposits as much as between currency and savings deposits. Thus, the immediate impact of monetisation in rural areas would be primarily on currency holdings and secondarily on the deposit base of the savings banks, (Chandavakar, Anand G., 1977). Since, however, there is no determinate transmission mechanism between monetisation and the degree and composition of financial intermediation, it is difficult to generalise even on the direction of impact of initial monetisation on the portfolio behaviour of financial intermediaries.

6.3 Money Supply and Monetary Policies

6.3.1 Introduction

In the Sudan, as in many LDCs, banks during the colonial periods served mainly expatriates who were engaged in developing exports of raw materials. Indigenous people participated in the process of intermediation as depositors only rather than borrowers.

With independence, colonial domination of the banks began to disappear but colonial legacy was obvious on national banks. Hence, a very similar banking system has evolved where favoured private and official borrowers still absorb the limited finance available at low rates of interest, which are often far below the opportunity cost of scarce capital. The mass of small farmers and small-scale industry remains financially repressed.

Few agricultural loans are made by the organised banking system; and facilities for holding deposits offer limited physical accessibility in rural areas, and rates of interest paid on deposits are low. This limited existence of organised banking in rural areas, on both the deposits and lending sides, raises the costs of financing inventories of agricultural produce, making it high for traders as well as farmers and ensures marked seasonal variation in grain prices.

Together with the government, urban borrowers absorb virtually all of the banks' lending resources. Huge interest differentials between organised banking and informal rural credit is usual in the Sudan as in other LDCs.

However, characteristic features of the financial system in general can be summarised as:

(i) Government-owned financial institutions have a major role in the financial system.

(ii) The financial system is relatively limited, typically being composed of a number of commercial banks, a few specialised banks, and a saving bank.

(iii) Another key feature is the borrowing requirements of the public sector. Irrespective of the political system, the public sector tends to be by far the major borrower in the financial sector. Although the large credits to government in the Sudan is a direct consequence of the large proportion of government investment in total investment, an important part of these funds also goes to finance the current budget deficit.

(iv) A further striking characteristic of the financial system is the importance of the central bank as a primary source of funds to the economy.

(v) Traditional money-lenders are an important complement to the organised financial markets. These money-lenders provide financial services to the rural areas. High administrative costs and risks associated with the handling of the small loans required by these sectors make them unprofitable to the organised financial sector. These informal markets charge interest rates substantially in excess of the maximum lending rates allowed on loans by the organised markets.

(vi) Foreign participation in the financial system is important. There is a tendency for the government-owned banks to cater to the non-financial public enterprises, while the foreign-owned banks deal with the foreign-owned firms. These foreign banks also tend to concentrate their activities in the financing of export-import operations, while showing only marginal interest in financing other ventures, (Leite, Sergio P., 1982).

(vii) Finally, domestic savings in general, but financial savings in particular, have been declining in recent years, and gross domestic savings registered negative growth.

6.3.2 Growth of money supply

Prior to independence the currency circulated in the Sudan was the Egyptian pound which had been established in 1949 at the par value of U.S.\$ 2.8716 to the pound, (Lees, Francis A. and Brooks, Hugh C., 1977). The Sudanese pound was introduced in 1957, retaining the same par value relative to the U.S. dollar. When the United Kingdom and other important partners devalued their currencies the Sudanese pound retained its valuation relative to the dollar, thereby achieving an upward revaluation in terms of the devalued currency.

Up to 1977 the Sudanese pound retained its previous value. In 1978, it was devalued to an equivalent of U.S.\$ 2.50. After then it has been devalued repeatedly due to the financial difficulties, (internal and external imbalances) facing the Sudan economy (see Chapter V). Exchange control is administered by the Bank of Sudan, with responsibility for effecting detailed transactions delegated to the authorised banks.

The money supply and liquid asset holdings by the public have expanded noticeably over years. This reflects growth of the banking system, further development of a money-oriented economy and favourable incentives towards saving and capital formation.

Table 6.1 contains data pertaining to the growth of money narrowly defined as m_1 (currency and current deposits) and more broadly defined as M (including m_1 plus m_2 where m_2 is quasi-money), compared with the expansion of GDP from

Table 6.1: Growth of Money Supply & GDP (LS. million)

Years	Narrow money (m_1)	Quasi-money (m_2)	Total money supply (M)	GDP	$\frac{m_1}{GDP}$	$\frac{m_2}{GDP}$	$\frac{M}{GDP}$
1960	43.18	8.90	52.08	386.80	0.11	0.023	0.135
1961	51.83	4.30	56.13	420.00	0.123	0.01	0.134
1962	60.23	4.80	65.03	456.20	0.132	0.011	0.145
1963	69.44	6.00	75.44	464.10	0.15	0.013	0.163
1964	60.55	4.40	65.75	476.80	0.127	0.011	0.138
1965	64.72	6.50	71.22	496.90	0.130	0.013	0.143
1966	71.98	8.40	80.38	497.60	0.145	0.017	0.162
1967	77.57	11.00	88.57	536.30	0.145	0.020	0.165
1968	80.66	12.00	92.66	582.20	0.138	0.020	0.159
1969	96.92	13.40	110.32	602.60	0.161	0.022	0.183
1970	103.01	13.60	116.61	637.60	0.162	0.021	0.183
1971	117.93	15.40	133.33	701.30	0.168	0.020	0.188
1972	142.51	21.40	163.91	707.30	0.201	0.030	0.231
1973	172.46	29.40	201.86	832.70	0.207	0.035	0.242
1974	224.07	40.30	264.37	1136.90	0.197	0.035	0.233
1975	256.32	47.60	303.92	1379.70	0.186	0.035	0.220
1976	315.75	66.90	382.65	1661.80	0.190	0.040	0.230
1977	438.70	99.80	538.50	2599.10	0.169	0.038	0.207
1978	590.37	127.00	717.37	3007.50	0.196	0.042	0.283
1979	770.82	145.70	916.52	3253.80	0.237	0.045	0.282
1980	1061.45	166.70	1228.15	4072.10	0.260	0.041	0.302
1981	1330.25	268.90	1572.15	4792.70	0.272	0.056	0.328
1982	1696.31	428.90	2125.21	6217.90	0.273	0.069	0.342
1983	2181.49	624.30	2508.79	9185.80	0.237	0.068	0.305
1984	2629.90	650.55	3310.40	11329.00	0.232	0.060	0.292
1985	4400.55	867.80	5322.50	12788.00	0.344	0.068	0.412
1986	7756.10	1837.10	9593.20	21354.00	0.457	0.011	0.468
1987	7773.30	2634.10	10407.40	30676.00	0.25	0.090	0.34

Source: Bank of Sudan Annual Reports, various issues.

1960 to 1987. m_1 increased from approximately 11% of GDP in 1960 to nearly 20% of GDP in 1975, and to about 46% of GDP in 1986. Over the same period, m_2 , including time and saving deposits, rose from an extremely low base, 2% of GDP in 1960 to 11% of GDP in 1986. Consequently m_1 increased more rapidly relative to GDP over the 27-year period.

However, the increased relative importance of m_1 and M to GDP is to be expected at this stage of development for the Sudan. Moreover, the growth of M relative to GDP should continue as financial savings accumulate in the form of bank deposits. Inflationary pressures threaten the financial position of the economy. If, however, unchecked they would strongly discourage accumulation of financial savings via the growth in time and savings deposits.

6.3.3 The Monetary policies

The government follows a low interest rates policy taking into consideration three objectives: (i) the desire to increase the level of investment; (ii) the desire to improve the allocation of investment among sectors; and (iii) the desire to keep financial costs down so as to avoid the possible inflationary effects of interest rate liberalisation. But the interest rate policy was not effective. The Central Bank has relied primarily on control of rediscounting, and on quantitative credit controls for control of the money supply.

Because the public sector was a major borrower during most of the 1970's and till now, monetary policies have in general been accommodating and have only become more restrictive under the pressures from external imbalances and inflationary tendencies which have required stabilisation programmes. The need to provide for the credit requirements of the public sector while at the same time curtailing, to the greatest extent possible, the increase in the money supply, has forced the authorities to crowd out the private sector through the use of selective rediscounting and qualitative credit controls.

Faced with a deteriorating balance of payments situation and an increasing inflation rate, the monetary policy in the Sudan has become stricter. Each bank was given a monthly ceiling on credit expansion and is required to keep high liquidity ratios with the Central Bank. Despite this high liquidity requirement, the

banking system continued to have excess liquidity for two reasons: first, a large portion of commercial banks' credit to the private sector went for the financing of imports and, second, the lack of foreign exchange caused payments arrears which both decreased the use of import financing and left the banks with large deposits which corresponded to the domestic counterpart of foreign imports payments.

In the Sudan, the financial market distortions were often accentuated by intervention policies directed towards keeping the nominal interest rates unduly low and by the enlargement of government deficits financed by recourse to the banking system.

6.4 Growth of Banking System

The financial super-structure that needs to be built by the Sudan, like other LDCs, with the real infrastructure can best be evaluated by the opportunity of spreading financial institutions and the benefits that would be derived from increased savings and more efficient allocation of funds for financing investment.

The banking system in the Sudan has undergone significant development since the establishment of the Bank of Sudan on February 22nd 1960. Now, beside the Central bank, there are 24 commercial banks of which 5 are foreign banks. In addition, there are also 4 specialised banks. Commercial banks were nationalised in 1970; and although they were denationalised after a while, the entire banking system has been placed under the auspices of the public sector.

6.4.1 The Bank of Sudan

6.4.1.1 Establishment

Traditional functions of any central bank are summarised as: issue of currency and control of its purchasing power through monetary policies; act as the government bank and as a consultant in monetary affairs; acts as the banks' banker (that is, lender of last resort) and, finally, it manages the government's foreign reserves balances.

However, the Bank of Sudan as a central bank working in a developing economy is entrusted with other functions. It was required to undertake an effective role in

the economy by using all monetary and credit policies to enhance and push ahead economic and social development.

The start of the Bank of Sudan was synchronised with the launching of the first 'Ten-year Plan(1960/61-1969/70). The Bank of Sudan undertook the responsibility of adopting monetary policies that could increase production and create a surplus in the central government's budget so as to finance the projected plan. Therefore, it formulated monetary and credit policies designed basically to direct credit financing to the different productive sectors and to foreign trade, in particular exports which, using exports proceeds, finance imports of machinery and equipments and other production inputs. At the same time the Bank of Sudan restricted financing of imported non-essential consumer goods and of unproductive activities like residential investment and personal loans.

6.4.1.2 Monetary and credit policies

There is no record of the use of monetary and credit policies in the official notes and records of the Sudan Government before the establishment of the central bank. The reason for this is that, beside the absence of a central bank vested with the power of administering and controlling the money and credit flows, the then existing commercial banks were branches of foreign banks with almost full control on their operations by their head-quarters abroad.

The Bank of Sudan was established in 1959 by its Bank Act of that year and it started operation in 1960. It concerned itself from the start with formulation of monetary policies which aim at the realisation of monetary stability and at directing bank credit to useful and strategic economic activities in the interest of orderly and balanced economic growth.

In the sphere of direction and management of credit, section 5 of the Bank of Sudan *Act (1959)*, stipulates that among the main purposes of the Bank is to assist in the promotion of banking system and a system of money and credit in the Sudan and looking after its stability with a view to realising the economic development of the country in an orderly and balanced manner. To realise this important monetary and economic objective the *Act* has secured for the Bank all

the measures and powers which enable it to control the size of credit and direct it into the proper direction.

One of the credit control tools made available by the Bank of Sudan Act is the rate of interest or rate of discount or rediscount, known as the *bank rate*. Section 42 of the Act enables the Bank to establish differential rates for various classes of transactions or maturities. It is important to note here what has been stressed elsewhere about the ineffectiveness of interest rate policy in a country like the Sudan. This can be attributed to: (i) the highly restricted spread of banking habit, (ii) the religious and social causes which regard interest rate as usury, (iii) the short experience of the banking system and (iv) the limited non-banking finance. Another tool of monetary control is the power to fix and manipulate the cash ratio observed by commercial banks. Section 44 of the Act states that

'the Bank may require banks to maintain reserves in the form of deposits at the Bank or in such other forms as the Bank may stipulate in a specified ratio to their sight and time liabilities'. However, this monetary policy tool is not effective because most of the banking operations are short-term seasonal operations related to the seasonality of agricultural production. This, thus, makes it necessary for most of the banks to hold a high percentage of liquidity for most of the year. It is, therefore, not surprising that

'this tool of manipulating minimum fixed cash-ratios has never been popular with the Bank of Sudan from the date of its inception to the present time', (Ibrahim E., p. 8).

Since the above mentioned tools of open-market operations, that is interest rate adjustment and manipulation of cash ratios, depended for their effectiveness on the existence of a sophisticated structure of financial markets that do not exist in the Sudan, the Bank of Sudan relied significantly and, almost exclusively, on the tools of direct management and control of credit ceiling for each bank. Moreover, sub-ceilings for financing imports, and private and professional loans are also fixed within the overall ceiling for each bank, in consequence of requirements of the stabilisation and financial reform programmes imposed by the I.M.F. Within the framework of these programmes the total expected increase in commercial banks' credit to the private sector is determined. These ceilings are subjected to strict follow-up and surveillance to safeguard against banks exceeding the limit or misuse.

This monetary policy tool enjoys high degree of flexibility since the ceilings are reviewed periodically every three months.

Within the framework of setting ceilings on bank credit the Central Bank follows a policy of controlling not only the size of banks' lending but its type. The Bank of Sudan issues its directives to these banks to direct the greater part of credit to productive sectors. Moreover, an advisory committee for bank credit has been set up since March 1980 to take a final decision on all submissions for large credit facilities coming to the commercial banks.

So far, these are scope and tools of monetary policy exercised by the Bank of Sudan. One more notice can be added. During the period 1960-65 when public expenditure increased with launching of the first Ten-year Plan, and consequently, money supply increased as well, there were no strict monetary and credit policies. The period 1965/66-1970/71 was characterised by a substantial increase in the size of the obligation of the public sector to the banking system. In addition, there was deterioration in the position of foreign reserves, and an increase in current expenditure at the expense of capital expenditure. The monetary authorities decided to take severe measures towards the banking system which was nationalised in 1970.

6.4.1.3 Lending the government

Apart from controlling credit in the economy, the Bank of Sudan has a vital role in lending to both the government and public sector corporations. The Central Bank's law guarantees to the government the right of short-term borrowing to bridge the gap in the budget, (*Act No. 57*).

There are, however, similar acts in the laws of central banks in other Arab countries. For instance, the *Act 49* of the law of Central Bank of Jordan, *Act 53* of the law of Central Bank of Algeria, and *Act 4* of the law of Central Bank of Iraq, (El-Shoosh, Tag Elsir, 1977, p. 47). Governments in these countries make use of these acts in a reasonable manner; but the Sudan Government continues to abuse this facility and, consequently, to contribute to the distortion of the financial system.

The original *Act 57* allowed the government to borrow for short-term pur-

poses, up to 15% of its estimated revenue in a specific fiscal year, and the amount borrowed should be repaid within six months following an end of the fiscal year. Because of the increasing need for borrowing, the *Act 57* was amended repeatedly.

In 1962 the *Act 57* was amended and added to by the *Act 57(A)* which allowed also the government corporations to borrow from the Bank of Sudan, so that their borrowing would be within the limits specified to the central government (i e, 15% of its estimated revenue). In 1969 this *Act 57 (A)* was amended remarkably so that government corporations could borrow outside the limits specified for the central government borrowing.

The *Act* was amended for the third time in 1970 by the then new government for the purpose of restricting borrowing. The government borrowing limit was then reduced to 10% of its estimated current revenue and to be repaid within six months following closing accounts of the indicated fiscal year. This restriction extended for three years only and the *Act*, under pressures, was amended in May 1973 in such a way that the government, apart from temporary loans, could borrow to finance productive sectors. This was, in fact, a drastic change because the government was enabled to borrow without limit. Moreover, the government felt that it failed to repay debts, and this constrained it to borrow more, therefore it amended the *Act* automatically in 1974 to postpone repayment of debts to the Central Bank. Other amendments were made in subsequent years and debts of the government to the Bank of Sudan were frozen following a serious deterioration in financial position. In this way, these debts became long-term loans, instead of being of a short-term nature as stipulated by the *Act 57*. Financial records show that the government started borrowing since early 1964, and with the subsequent amendments the government depended wholly on deficit financing. Cumulative debts amounted to LS.5798.2 million in 1985 compared with LS. 610.8 million in 1977. Public corporations borrowing increased from LS. 143 million in 1977 to LS.1051 millions in 1985 and LS. 2099 million in June 1988 (Bank of Sudan, Economic and Financial Statistics Review, April-June 1988).

In this way, the size of the obligations of the public sector to the banking system increased substantially. The government, who had been a net creditor to the banking system, became a debtor. Under such circumstances of compound

internal and external imbalances in which the foreign reserves have fallen down to unprecedented low levels and in which the inflationary pressures have been obstructing the growth of the economy, the government resorted to the I.M.F. programmes of financial reform and stabilisation. The Bank of Sudan adjusted its policies – as mentioned earlier– to be consistent with the objectives of these programmes.

6.4.2 Nationalisation of commercial banks

Before the *Nationalisation Act of 1970*, the commercial banking system in the Sudan consisted of seven banks.¹⁸ The *Nationalisation Act* was an outstanding landmark in the development of the Sudanese banking system and the monetary and credit policies emanated from it. The government argued that banks were nationalised because of: (i) foreign domination and the drain of national economic surpluses; (ii) geographical imbalance in banks' distribution and their concentration in urban areas only; (iii) meager contribution to development and (iv) an absence of effective central control, (Bank of Sudan, *Nationalisation of Banks in the Sudan*, undated report, p.4). The nationalisation resolution aimed at development and improvement of banking services to various economic sectors, particularly in the traditional areas; putting an end to foreign domination and providing the Central Bank and the government with full power to control credit policies.

As was argued, the main disadvantage of foreign domination was that commercial banks operated mainly with deposits of the Sudanese and transferred the profits abroad. The capital of these banks were insignificant when compared with their deposits. It was found that total capital of these banks amounted to LS. 9.24 million only while their deposits were LS. 49.9 million. The total profit they transferred amounted to LS. 7.2 millions during the period 1960-1967.

Measured in terms of a number of branches and deposits mobilised and credit disbursed, banking facilities were concentrated in Khartoum and the central Sudan, while regions such as Darfour and the South remained backward so far as

¹⁸ These are Barclays Bank D. C. O.(British); National and Grindlays Bank (British); Bank Misr (Egyptian); The Arab Bank (Jordan); Commercial Bank of Ethiopia (Ethiopia); The Credit Lyonnais Bank (French, but 60% of its capital was owned by the Bank of Sudan); Sudan Commercial bank (founded in 1960 by the Sudanese private sector).

the growth of banking was concerned. It was found that out of 62 branches of commercial banks, 48 branches were in Khartoum, Gazera and Kassala provinces. Moreover, banks failed to convert very liquid assets into medium-and-long-term loans. Over the period 1960-1970, 80% of commercial banks' loans were short-term finance to the foreign trade sector only.

However, the nationalisation resolutions necessitated revising the relation between the central bank and the commercial banks, changing it from one of supervision and technical instruction to an organic relation of actual ownership. In 1971 the Bank of Sudan advanced another step in its strategy of controlling credit extended by commercial banks by raising cash deposits on imports to 40% of the value of imported commodities.

In the first two years of nationalisation the Bank of Sudan had followed in its monetary and credit policy a strictly independent path free from any commitment to the IMF. But in February 1972 the Sudan entered into a new stabilisation programme with the IMF as the government was faced with difficulties in carrying on nationalisation. These difficulties included the loss of foreign reserves to finance development projects, and inadequate trained staff to run the projects which were already supervised by the commercial banks.

6.4.3 Regulation of banks

While the position of the Central Bank to control banking system was enhanced after nationalisation, it was weakened relatively during the years 1973-1975. The year 1973 witnessed a passing of the *'Regulation of Banks and Savings Act'*, with a justification that the control of the Bank of Sudan over administrative matters of commercial banks was not one of its basic functions. Thus, the Bank of Sudan was left only with technical powers and functions.

However, an immediate outcome of this weakening of the Central Bank was that some banks expanded credits exceeding their limits. Among the harmful consequences of the *Act* was the huge rise in the size of bad debts of some commercial banks which undoubtedly resulted from the liberal and unguaranteed credit facilities.

In 1975 the government withdrew the *'Regulation of Banks and Savings Act'* of 1973 by passing *'Banks Nationalisation (Amendment) Act 1975'*. It also dissolved the *'Saving and Investment Council'* which was established earlier. By doing so, however, the Bank of Sudan was vested again with powers of control over banking system.

The banking system was affected latter by the programmes of economic concentration and financial reform agreed upon with the IMF. Among the objectives of these programmes were to check borrowing from the banking system and manipulation of the exchange rate for the Sudanese pound. The government, on recommendation from the I.M.F., set up a parallel market for foreign currencies side by side with the official market. It did so, however, without any preparatory or regulatory work for this market and without any stabilisation mechanism (for instance, an equalisation account or stabilisation fund) to enable the Bank of Sudan to interfere so that it could crowd out fluctuations and differentials between the two markets. Therefore, speculative and parasitic dealings predominated in the exchange market.

Thus far, this is a brief account of development in monetary and credit policies in the Sudan, which left their impact on the performance of commercial banks. What follows is a survey of the role of commercial banks in the mobilisation and allocation of savings.

6.4.4 Commercial banks

The influence of financial intermediation in the process of capital formation is reflected in three main functions: first, there is the role of collecting additional savings – especially from the household sector; second, their impact on the financialisation of these savings (i. e. savings in financial form); and third their ability to ensure the most efficient transformation of mobilised funds into real capital.

With regard to generating savings and allocating them efficiently, McKinnon argues

'By paying a rate of interest on financial assets that is significantly above the marginal efficiency of investments in existing techniques, one can induce the entrepreneur to disinvest from inferior processes to permit lending for investment in improved techniques and increased scale

in other enterprises. Even though all entrepreneurs will continue to do some internal investing, a higher proportion of gross savings will pass through the external capital market. The release of resources from inferior uses in the underdeveloped environment is as important as new net savings per se.' (McKinnon, Ronald I., 1973, p. 15).

A similar argument was expressed by Shaw when he writes

'Savers may ignore a possible transitory increase from say, 4 to 6 per cent in rates of return, but they are less likely to maintain consumption saving pattern when rates of return change, in a context of economic reform, from negative levels to positive 10 - 15 per cent and more. Given the relative scarcity of wealth in lagging economies, the income effect of return should not be expected to overwhelm the substitution effects of more wealth for less consumption now' (Shaw, E., 1973, p. 73).

However, the financial super-structure that needs to be built by the Sudan, as a developing economy can best be evaluated by the opportunity cost of spreading financial institutions and the benefits that would be derived from increased savings and more efficient allocation of funds for financing investment in the Sudan.

Theoretically, these are the basis on which the commercial banks should work. Performance of commercial banks can now be evaluated from this point of view.

6.4.4.1 Sectoral distribution of banking network

Banking system is composed mainly of commercial banks whose number is now 24 banks distributed as follows: 9 banks owned by the government, including three specialised banks and a saving bank, 5 foreign banks, 10 joint-venture banks owned by foreign and Sudanese shareholders. The banks maintain 315 branches 102 of these branches are run by joint-venture banks and 8 by foreign banks.

As for the public sector banks, these include the 4 foreign banks that were nationalised in 1970 and since then have been owned by the government.¹⁹ In 1983 the National Bank for Export and Import was set to finance foreign trade particularly commodity loans received by the government from foreign donors. The government established also the Islamic Co-operative Development Bank as a joint-venture with

¹⁹ Bank of Khartoum, El Nilien Bank, Unity Bank and the Sudanese Commercial Bank.

the co-operative unions and now the bank is offering shares for subscription by the private sector.

Joint commercial banks are owned by the Sudanese private sector and its foreign counterpart (both individuals and corporations). There are 10 joint banks including 6 Islāmic banks.

On the other hand, foreign commercial banks are, generally, branches for foreign banks. They have been authorised to expand the base of the national economy by providing capital for the needy public and the private sector. Any foreign bank is required to transfer inside the country a minimum of U.S.\$ 10 million of its capital, and it should concentrate on financing medium-and-long-term investments. In addition, a foreign bank is not allowed to receive any type of deposits in local currency unless a customer needs it for foreign trade operations or he/she is an expatriate.

Besides commercial banks there are four specialised banks, the Agricultural Bank, the Industrial Bank, the Real Estate Bank and the Sudanese Saving Bank.

As for non-banking financial intermediaries, the Post Office Savings Banks are also involved in various credit activities which include the selling of premium bonds. Insurance companies have also played a relatively limited role in attracting private savings. In addition there is the Sudanese Development Corporation and the Sudanese Rural Development Company for financing development projects.

6.4.4.2 Geographical distribution of the banking network

Although the growth of financial intermediaries in absolute terms is essential for achieving economic transformation, the geographical dispersal of their expansion among various regions is central to the realisation of full monetisation of the entire economy.

In terms of an absolute growth of banking branching, the number of branches increased from 91 in 1977 to 176 in 1980, 265 in 1986 and 315 in 1988. However, most of the reasons for nationalising commercial banks in the Sudan was their concentration in urban areas. The available evidence reveals that efforts to achieve the latter objective in the Sudan have been meager. It is obvious that banking

facilities have almost exclusively been concentrated in Khartoum province. Out of 176 branches operating various banking facilities in 1980, 59% were founded in Khartoum. In recent years, there is an improvement with regard to banking services in rural areas. In 1988, out of 315 branches of operating banks, 33% were placed in Khartoum and 54% of their services in Khartoum and the Central Region, (Table 6.2).

On the other side backward regions, which include the bulk of the inhabitants of the subsistence sector, were suffering from a scarcity of banking services. This has led to the concentration of credit activities on a tiny fraction of the economy, (El Shibly, Mekki M., 1984).

This limitation of banking services hindered the promotion of the banking habit in rural areas as long as banking facilities are physically absent. One study found that in 1977, 79% of total deposits with commercial banks originated in Khartoum province, (*F. Ibn Idris, 1977*). This is an evidence, however, that the amount of savings depends partly on how widespread these facilities are. People are expected to save more when financial institutions are nearer than if they are distant.

6.5 Deposits Liabilities and Interest Rates

Since deposit liabilities of non-banking financial institutions are relatively insignificant, a close approximation to the community's aggregate savings in financial form can be observed by the size of deposit liabilities of commercial banks. Table 6.3 portrays the growth of central government and private sector deposits with commercial banks between 1960-1987.

It is readily obvious from the table that private deposits dominate the total deposit liabilities of the commercial banks, reaching 99% of the total in 1982 and 86.1% in 1986. Authorities of the Central Bank attributed this substantial increase in deposits to the spread of banking habits, associated with the expansion of commercial banks' services in addition to an increase in foreign currency deposits.

Authorities of the Central Bank also attributed this increase to the rise of the interest rates in commercial banks. This claim calls for an examination of the

Table 6.2: Development in Spread of Banks

Regions	Bank of Sudan				Specialised Banks				Other Gov. Banks*				Joint Banks				Foreign Banks				Total			
	1960	1980	1986	1988	1960	1980	1986	1988	1960	1980	1986	1988	1960	1980	1986	1988	1960	1980	1986	1988	1960	1980	1986	1988
Khartoum	1	1	1	1	1	7	9	6	12	41	49	52	-	5	25	39	-	5	7	7	14	59	91	105
Central Region	-	2	2	2	-	10	21	24	-	20	22	22	-	-	11	17	-	-	-	1	-	32	56	65
Eastern Region	-	2	2	2	-	3	4	7	6	18	16	22	-	4	16	17	-	2	1	1	6	29	39	51
Northern Region	-	1	1	1	-	6	8	8	2	6	6	7	-	-	8	12	-	-	-	-	2	13	23	28
Kordofan Region	-	1	1	1	-	5	7	6	2	11	15	15	-	-	3	10	-	-	-	-	2	17	26	32
Darfour Region	-	1	1	1	-	2	2	3	-	9	7	9	-	-	3	6	-	-	-	-	-	12	13	19
Southern Region	-	1	1	1	-	2	4	4	-	11	11	11	-	-	1	1	-	-	-	-	-	14	17	17
Total	1	9	9	9	1	35	55	58	22	116	126	138	-	9	67	102	-	7	8	8	24	176	265	315

* Commercial banks.

Source: Bank of Sudan Annual Reports, various issues.

Table 6.3: Growth of Deposits (LS. 000s)

Years	Government Deposits		Private Deposits		Total	Index of total deposits
	Amount	%	Amount	%		
1960	13606	44.7	16855	55.3	30471	100
1961	10200	33.7	20106	66.3	30306	99
1962	12054	33.8	23608	66.2	53662	177
1963	15597	36.5	27159	63.5	42756	141
1964	2542	8.2	28319	91.8	30861	102
1965	2177	6.2	32607	93.8	34883	115
1966	1294	3.4	36281	96.6	37575	124
1967	1539	3.5	42822	96.5	44361	146
1968	1295	2.9	42864	97.1	44159	145
1969	1399	2.8	48485	97.2	49884	164
1970	2249	3.9	54875	96.1	57124	186
1971	3332	5.4	58360	94.6	61692	202
1972	4933	5.7	81352	94.3	86285	283
1973	4272	4.0	101538	96.0	105810	347
1974	5136	3.6	136231	96.4	141367	464
1975	5952	3.5	165231	96.5	171917	564
1976	8057	3.6	213058	96.4	221115	726
1977	16014	4.9	313150	96.1	329164	1080
1978	19858	4.8	405296	95.2	415154	1395
1979	15650	2.9	528805	96.4	544455	1786
1980	13059	1.8	694824	98.2	707883	2323
1981	25234	2.7	908500	97.3	933734	3064
1982	12379	1.0	1305044	99.0	1317423	4323
1983	21503	1.2	1709015	98.8	1730518	5679
1984	24437	1.2	1964073	98.8	1988510	6526
1985	261039	7.3	3280817	92.7	3541856	11623
1986	688066	13.9	4243712	86.1	4931778	16185
1987	1381605	19.3	57863	80.7	7167979	23524

Source: Bank of Sudan Annual Reports, various issues.

breakdown of deposits between current, demand and savings deposits (Table 6.4).

In 1960, the percentage distribution of these deposits was as follows: current deposits 70%, time deposits 25.6% and savings deposits 4.2%. In 1975 these percentages were 72.1%, 4.8% and 23.1% respectively.

Considering that time deposits were exceptionally high in 1960, the figures imply that this particular type of deposits has kept a relatively constant small share out of the total. The reason behind this is that time deposits are not particularly attractive to commercial banks as they are deposited only for short periods.

Savings deposits have shown an impressive growth up to the year 1977. Although monetary authorities in the Sudan believed that this growth was due to increases in interest rate, but there is no evidence, however, to suggest that this steady increase was coming from the manipulation of the nominal interest rate.

Prior to 1974, the money interest rate on savings accounts was 4%. It was raised to 6% in 1974, 8% in 1975, 12% in 1981 and to 15% in 1983. Nevertheless, although the nominal interest rate increased by 100% between 1973 and 1975, the share of savings deposits in total deposits rose by less than 10% over the same period. Moreover, the share of savings deposits declined between 1975 and 1985 though the interest rate was increased by about 100% over the same period, (Table 6.4).

This small increase in the share of savings in total deposits is not, however, surprising if it is realised that the real rate of interest actually fell in those three years – 1973–1975 – from 0.5% to 0.4%. A subsequent fall in the real interest rate which characterised the period 1976–1986 had led to an even further decrease in the share of savings deposits until they reached only 12.3% in 1985 and 12.6% in 1987.

The Sudanese economy is lacking high savings ratios. According to the World Bank, projected gross savings will not exceed 13% of the GDP, (The World Bank, 1985). Gross savings as a ratio of the GDP were 12% during the period 1970-1974, 18% during 1974/75-1977/78 and 14% in the year 1985.

Given this fact, improving resource mobilisation in the private and joint sectors

Table 6.4: Types of Private Deposits (LS. million)

Years	Current		Time		Saving	
	Amount	%	Amount	%	Amount	%
1960	21.4	70.2	7.8	25.6	1.3	4.2
1961	26.1	86.2	2.6	8.2	1.7	5.6
1962	30.8	86.5	2.1	6.0	2.7	7.6
1963	36.8	86.1	2.4	5.5	3.6	8.4
1964	25.7	83.2	0.8	2.7	4.4	14.1
1965	28.3	81.1	1.3	3.9	5.2	15.0
1966	29.2	77.1	1.6	4.3	6.8	18.0
1967	33.3	75.2	3.0	6.8	8.0	18.0
1968	32.2	72.9	2.3	5.2	9.7	21.9
1969	36.5	73.1	2.2	4.4	11.2	22.5
1970	34.5	76.2	2.0	3.5	11.6	20.3
1971	46.3	75.0	1.3	2.1	14.1	22.9
1972	64.6	75.2	2.4	2.8	19.0	22.0
1973	76.4	75.2	5.1	4.8	24.3	23.0
1974	101.1	71.5	5.9	4.1	34.4	24.3
1975	124.0	72.1	8.2	4.8	30.7	23.1
1976	157.9	70.3	14.2	6.3	52.7	23.4
1977	233.2	70.9	22.3	6.7	77.5	23.3
1978	303.3	70.3	33.5	7.8	93.6	21.8
1979	404.2	73.4	39.7	7.2	106.0	19.3
1980	553.3	76.8	51.0	7.1	115.7	16.1
1981	673.5	71.5	115.0	12.2	153.9	26.3
1982	875.9	67.1	218.1	16.7	210.9	16.2
1983	1157.0	64.9	275.0	15.4	349.3	19.7
1984	1382.9	67.0	378.1	18.3	302.4	14.7
1985	2754.7	76.0	423.6	11.7	444.2	12.3
1986	3299.8	64.2	1107.1	21.5	730	14.3
1987	3530	61	1530	26.4	726	12.6

Source: Bank of Sudan Annual Reports, various issues.

involves encouraging them to lower consumption. The primary policies for achieving this are raising real interest rates and altering prices. At present, interest rates are used neither to allocate credit nor to manage aggregate demand. All interest rates are negative in real terms and encourage consumption rather than savings. All of the intermediation between the private and public sectors, and within the public sector, occurs at much lower nominal interest rates. Rather than imposing real interest rates, the government has chosen to impose quantitative controls on credit for the short-term and to seek to reduce the rate of inflation over the medium-term, thereby increasing the real interest rate. The lack of real interest rates and capital charges had adversely affected both the mobilisation and use of domestic resources. Important evidence comes from the private sector investment patterns. Recent tendencies in holding of foreign assets by the private sector indicates the private sector lack of interest in investing in domestic assets, be they real or financial. Since most of these foreign assets probably consists of increased holdings of foreign currencies,

‘ it is likely that the build-up reflects the potential earnings that can be made by investing in greater stocks of imports and/or of taking advantage of expected exchange rate devaluations’, (The World Bank, 1985, p. 77).

Another evidence of the impact of negative interest rates in the economy is the increasing amount of investment in residential construction and stocks of traded items. Both of these are profitable during periods of rapid inflation and negative interest rates, but do little to help the production of tradeable goods.

Positive real rates would encourage savings and productive investments and would discourage hoarding of goods.

It is important, however, to mention here that during the ten-year period 1975-1985, there was a remarkable change in the distribution of deposits between the public sector banks on the one hand, and the private, foreign and joint, banks on the other hand. The portion of deposits in government banks to total deposits declined from above 95% in 1977 to less than 59% in 1985. This came from an increase in the number of foreign and joint-venture banks. In 1976 there were only 2 foreign banks, now there are 16 private banks. Hence some depositors shifted their balances to these banks, especially those who work in the field of foreign trade and

this section of depositors is from the high-income group. In addition, the majority of Sudanese Nationals Working Abroad transfer their savings through the foreign banks which have branches in the areas of concentration of these Sudanese workers, and the deposits of foreign banks are inflated as a result of subsequent devaluation of the national currency, the Sudanese pound.

6.6 The Allocation of Deposits

Turning to investigate how the deposits mobilised have been channelled to finance investments, this provides a test to whether the Sudanese commercial banks have performed successfully as a conduit for transferring resources to the most socially desirable investment activities.

Between 1960-1986 commercial banks advances to the private sector grew seventy-fivefold from LS. 34.8 million to LS. 2644.3 million. A big jump occurred in 1974 and since then there are successive increases especially since 1977, the period that witnessed the start of a number of banks. Another jump was synchronised with a second expansion in banking services in early 1980s.

For the most part these advances have been of short-term nature (maximum 12 months). On average commercial banks have been issuing 60% of their total advances on a short-term basis during the period 1980-1986. This tendency originated during the colonial era and had been one of the causes leading to nationalisation of the banks as shown earlier in this chapter. There is no reason why this trend should have continued since the entire banking system has been placed under the supervision of the Bank of Sudan.

The whole pattern of lending has been dominated by the financing of foreign trade, (Table 6.5). That has been particularly the case with respect to advances to finance exports which increased from LS. 67.7 million in 1975 to LS. 149.5 million in 1980 and to LS. 775.1 million in 1986. On the import side, despite the restrictive monetary policy imposed by the Bank of Sudan, advances to finance imports increased up to 1984 while they were slowing down in 1985 and 1986.

It is also readily evident from the table that there is an obvious bias against

Table 6.5: An Analysis of Banks Advances (LS. million)

Years	Short-term Advances (max. 12 months)						Others	Medium & long-term	Grand Total
	Financing working capital			Financing foreign trade					
	Agriculture	Industry	Total	Exports	Imports	Total			
1960	437	4245	4682	15945	5926	21871	790	7548	34791
1961	565	4497	5062	21241	6895	28136	1542	1198	38938
1962	412	5114	5526	20506	9554	30060	4239	6862	46587
1963	722	7959	8691	25936	12523	38459	6282	6499	59881
1964	864	7205	8069	22451	11261	33711	6031	7544	55355
1965	930	7575	8505	15916	9452	25368	5119	6756	45748
1966	722	8430	9152	19031	8331	27362	4770	8235	49419
1967	584	10534	11118	26714	10322	37036	4878	9457	62489
1968	362	12251	12613	35964	7128	43146	5379	9685	70817
1969	279	14271	14550	32974	5463	38437	5391	8687	66065
1970	215	14970	15285	31554	8521	40075	6256	9214	70830
1971	358	7709	18067	24808	10117	34925	6943	9895	69830
1972	445	21874	22319	35053	7053	42106	9771	10591	84787
1973	513	31109	31622	30421	8799	39220	20014	7924	98780
1974	436	39992	40428	38975	10691	49666	21749	11372	123215
1975	455	59456	59911	67708	14603	82311	32637	11212	186071
1976	466	74028	74527	81915	15849	97764	37738	18365	201394
1977	439	75138	75875	85298	22976	108274	38752	41421	265322
1978	637	106979	107616	93080	39193	132273	51222	52117	343228
1979	2575	135492	138067	111101	47950	159051	68119	95666	460903
1980	4828	170430	175258	149513	60977	210440	77018	130145	592861
1981	1481	227101	228582	162084	125172	287256	95324	166364	777526
1982	3478	268256	271734	298195	204300	502495	125291	243017	1142523
1983	4394	276177	280571	311769	241987	553747	167385	375218	1376923
1984	5418	255850	261268	357860	298309	656169	207704	454047	1609191
1985	2619	384537	378156	342790	230188	572978	245756	570819	1776709
1986	6734	424171	430905	775120	157009	932129	646551	634746	2644331

Source: Bank of Sudan Annual Reports, various issues.

financing working capital in agriculture.²⁰ In 1960 advances for this purpose amounted to 9.3% of the total sum allocated to finance working capital. This share has declined consistently reaching less than 1% in 1975, it was 0.5%. It rose slightly to 0.8% in 1980, but declined again to an insignificant share of 0.3% in 1986.

Taking into consideration the extreme difficulties encountered by the Agricultural Bank in meeting the excessive demand for loans, the impact of this attitude of commercial banks on the overall development is largely unfavourable. It is a fact that loans to the agricultural sector are surrounded with uncertainty. But it must not be forgotten that agricultural activities are still the cornerstone of the Sudanese economy. Moreover, by adopting such a policy, the commercial banks are drifting away from achieving a major role in modernising the economy, that is, through monetising the traditional sector. As will be disclosed in section 6.8 below, farmers in rural areas are exposed to money lenders who charge exorbitant interest rates which are carried out through the *shail* (agricultural credit) system characterising rural credit activities in the Sudan as, similarly, in a number of other developing economies.

However, although commercial banks are blamed for shying away from long-term investment in productive activities, some obstacles forced commercial banks to concentrate on short-term financing. One obstacle is an absence of capital and money markets for exchanging of local shares and securities. If such markets were formed, commercial banks could have issued long-term securities and could avoid liquidity difficulties that might be encountered in financing development projects. Moreover, commercial banks suffer a lack of versed-staff to design, implement and follow-up studies of long-term investments.

6.7 Lending Activities by the Specialised Banks

As the commercial banks credit operations are largely motivated by liquidity and profitability, the establishment of development-oriented banks is necessary. In the Sudan four specialised banks were subsequently established to help promote

²⁰ Figures on Table 6.5 exclude advances by specialised banks.

economic development in the agricultural, industrial and housing sectors of the economy.

- The Agricultural Bank was established in 1959 with an authorised capital of LS. 5 millions. By 1985, the paid-up capital has been increased to LS. 35.8 millions, and is fully paid; part of it is subscribed by the Bank of Sudan. It grants loans to small and medium farmers as well as co-operatives; while public corporations (e.g. the Sudan Gazera Board) borrow directly from the Central Bank. The Agricultural Bank provides different kinds of loans:

(i) Short-term loans, the purpose of which is to make it easy for both farmers and producers to meet production expenses of harvesting, marketing and others. These loans are repaid within a 15 month period or immediately after harvesting the crops.

(ii) Medium-term loans for purchasing agricultural equipment and the improvement of irrigation devices like digging of wells, purchase of pump machines, construction of small stores, loans for animal production (dairy and beef cattle). These are repaid in a maximum period of 5 years.

(iii) Long-term loans for the construction of new large schemes, or maintenance of the existing ones and the digging of canals, (The Agricultural Bank of Sudan, 1979, p. 11).

Total loans granted by the bank in 1980 amounted to LS. 4.7 million and jumped to LS. 76 million in 1986 and LS. 85 million in 1987, 79% of which were of short-term nature. A big share of the bank's credit did favourably go to farmers in rural areas, especially in the Central and Eastern regions of the country.

- The Industrial Bank of Sudan was established in 1961. The main objectives of the Bank as it is specified by its *Act* are:

(i) Providing financial assistance for the modernisation or expansion of existing industries, and the promotion of private industrial enterprises.

(ii) Furnishing technical assistance and investigating the economic and technical feasibility of new industrial projects.

The authorised capital was LS. 5 million, increased in 1985 to LS. 18 million and is fully paid-up. The bank concentrates on industries that are in rural areas and use local materials like edible oil, textiles, glucose and starch industries, and workshops and crafts.

Loans are ordinarily granted for periods less than 2 years and not exceeding 15 years (2 to 6 years for medium-term and 6 to 15 years for long-term loans). The rates of interest charged were 8.5% on medium-term and 9.5% on long-term loans throughout the period 1962-1970. Commitment charges on undisbursed loans amount to 0.75%. The bank can invest up to two-thirds of the capital of any enterprise (see Chapter X, section 10.4.2).

- In 1967, the Real Estate Bank was established for the purpose of providing financial assistance in the housing sector. Its authorised capital, which was LS. 7 million, has been increased to LS. 15 million which is now fully paid-up. The bank granted loans amounting to LS. 2.8 million in 1980 and LS. 3.9 million in 1986 and only LS. 1.2 million in 1987. Only 13% of these loans were extended to low-income groups in 1986. The interest rate charged by the Bank are 4.5% for loans to low-income groups, 5% for middle-and-high income groups, and 10% for commercial loans. In order to meet its increased lending operations, the Bank recently liquidated its fixed assets.
- At the end of 1974, the Sudanese Savings Bank was established by the government in a rural town, Wadi Medani, the capital of the Central Region, as a pilot scheme. The authorised capital, being LS. 3 million, has been increased in 1987 to LS. 15 million and is fully paid-up. The Bank receives saving, investment and current deposits. Its saving deposits recorded a pronounced rise of LS. 41.7 million from LS. 88.4 million in 1985 to LS. 130.1 million in 1986, (Bank of Sudan, Annual Report, 1986). This was attributed mainly to an expansion of the Bank's branches. Total facilities extended to customers were LS. 8 million in 1980 and rose to LS. 96.6 million in 1986.

6.8 The Informal Money Market

Interest rates on privately made loans in underdeveloped rural areas are notoriously high, and this is understood as a serious hindrance to economic growth.

However, the explanation for why non-monetary economic activities survive so extensively in many LDCs has been sought in terms of poverty, isolation, tradition and inflationary pressures. While these factors are partly relevant, the more basic rationale is that under conditions of high risk and uncertainty in these economies, what the farmers seek, according to Lipton, are

'survival logarithms, not maximising ones', (Lipton, Micheal, 1968, p. 331).

However, before examining the factors affecting rural interest rates, here are, first, the main features of this market.

6.8.1 Main features

The following are the four prominent features of rural agricultural credit characterising many LDCs:

Sharecropping

The method of sharecropping is very extensively used. The land-owner leases his land for at least one full production cycle and the net harvest is shared between the tenant and the land-owner on some legally stipulated basis. The tenant may also have his own land and may supply working or fixed capital. There are, on the other hand, agricultural workers who work on a daily or weekly wage basis - paid in kind or in cash.

Perpetual indebtedness

The tenant is almost always heavily indebted. A substantial portion of the tenant's legal share of the harvest is taken away immediately after the harvest as a repayment of past debts with interest, thus reducing his actual available balance of the harvest well below his legal share of the harvest. This does not usually leave the tenant with enough food to survive from this harvest to the next and the serious problem of survival from harvest to harvest can only be overcome by borrowing for consumption. This perpetuates the indebtedness of the tenant on his regular requirements of consumption loans.

Landowner as the lender of consumption loans

The lender of the consumption loan is also typically the tenant's landowner. Thus the tenant leases his land from the same man to whom he is perpetually

indebted.

Inaccessibility to the market

First, the tenant is usually not creditworthy in any commercial banking sense because he has no asset to borrow against. Second, the tenant does not usually have access to the 'commodity market' as a seller of his product. Unlike a proper trader, he cannot usually take advantage of price fluctuations in selling his products. In the local village market, prices of crops show wide seasonal fluctuations. Lower prices are reached right after the harvest, while peak prices prevail sometimes before the harvest. Having run out of his available balance of crops from the last harvest, the tenant typically borrows at a time when the current market prices are very high, while he has to pay back just after the harvest when current prices are at their lowest. This practice, however,

'implies a fantastically high interest rate', (Amit, Bhadri, 1983, p. 124).

6.8.2 Factors affecting rural interest rates

Though high rural interest rates are attributed to the uncertainty involved, the premium for risk is not, of course, the only factor involved in the determination of rural interest rates. The reward for sacrificing liquidity as well as the administrative costs on the funds loaned will also play their part in forcing up the cost of lending. Moreover, wherever interest rates more than cover these charges, they will contain an element of monopoly profit. It seems likely, however, that administration and risk will be the more important factors governing interest rate determination in the developing economies in general.

A. Bottomley concentrates on (a) risk and (b) administration costs as causes of high rural interest rates in underdeveloped countries. He discusses risk as a determinant of these high rates under two broad headings, namely secured loans and unsecured loans.

Secured loans

Naturally the premium for risk will be smaller where the collateral on a loan is considered to be more adequate. The lender's risk will decline as the estimated value of the security offered first approaches and then exceeds the value of a loan.

Generally speaking, therefore, a building up of the value of a borrower's assets relative to the amount of credit which he needs will allow him to offer even better security and this will encourage the lender to reduce his premium for risk progressively.

In underdeveloped countries two major considerations stand out in this respect. They are the marketability of collateral and movements in the market value of collateral.

Security on rural loans will comprise either a farmer's fixed assets such as land, capital equipment and gold ornaments; or his current assets such as crops in the process of production or storage. In the case of fixed assets, certain problems regarding their marketability arise. It is, for instance, frequently difficult to establish title to land in poor countries and it may, therefore, stand as a doubtful security on a loan. Even where titles are clearly defined, it often happens that no one will bid on land when it is offered for sale upon foreclosure. In many Muslim states it would be against the prevailing code for any one to try to purchase the assets of a neighbour which might be put on the market in this way.

The absence of clearly defined legal rights to assets offered as collateral, and the existence of the kind of social pressures mentioned above will raise the risk of lending against security. Such considerations as these must, as put by Bottomely

'share the responsibility of the prevalence of high interest rates throughout the underdeveloped world', (Bottomely, Anthony, 1963, p. 634).

Farmers in underdeveloped countries usually allow the value of collateral under their care to decline. This is particularly likely to happen where loans are made for mechanical innovations, or against crops which are in store. For instance, farmers in the Sudan are in the habits of storing their harvested crops in holes in the ground, *'matameer'*, and these crops commonly deteriorate by as much as 25% a year.

It is also obvious that default will most probably occur when produce prices fall. Not only will security in growing crops decline in value at such a time, but the desire and the ability of otherwise solvent farmers to bid on assets offered for

sale upon foreclosure will be much reduced. Furthermore, the sharpness of this tendency will always be correlative with the narrowness of the market.

If, however, the the sale of crops or land faces the narrowly inelastic demand of a market which is narrowly limited in terms of areas as well as purchasing power, such as commonly occurs in poor countries, then relatively small fluctuations in supply will drastically alter the value of either current or fixed asset collateral when it comes to a sale.

Unsecured loans

In many parts of the underdeveloped world, loans are often made against no better security than the farmer's verbal promise to discharge his obligations. In these circumstances the question of risk narrows to the farmer's willingness to pay and his ability to repay. One of the main reasons why government banks and co-operatives in LDCs frequently fail to cover their costs of operations, is the fact that farmers very often regard an advance in which the government has a hand more as a gift than as a loan. Costs of recovery are therefore high and the risk of default is considerable. However, this problem is minimised when the village money lender is concerned because, first, there is little chance for a borrower to escape the money lender's eye and, second, the money lender has different degrees of hold on those to whom he chooses to lend. All of these forces will be in operation to induce repayment to private money lenders.

A farmer's ability to repay is not always commensurate with his willingness to repay. In the long-run a farmer must provide for his family subsistence regardless of whether he can repay his debts or not. If a farmer's harvest fails again and again, there will come a time when he will feel that he has accumulated debts, together with the interest owed, which cannot possibly be repaid.

However, increasing the actual marketable surplus out of which the farmer can pay his debts will only be of small avail, and may be harmful, if the increased supply of produce meets a highly inelastic demand when it is offered for sale. Therefore, the failure to grade, store and freeze together with the lack of transport facilities, will tend to perpetuate narrow market conditions, under which added production may also be sold at sharply falling prices.

Administrative costs

Confining the enquiry to the administrative costs on private money lending, why then do these costs in underdeveloped rural areas appear to be so high and what can be done to reduce them?

The money lender will have a schedule of costs per unit of his operations, and a part of this cost schedule will arise from the charges on administering his loans.

The money lender is unable to fully utilise his capacity to administer loans and the high cost of administration even where the money lender's capacity is fully employed. Subordinate to these basic considerations are : the number of individual loans which the money lender makes; the size of each loan; the average length of time for which he makes them and, finally, the administrative cost of providing the money lender with whatever additional reserves he may feel he needs.

6.9 *Shail* System in the Sudan²¹

The nature and extent of Sudanese banking facilities in the organised market have been examined. Significantly, only 25% of the total population are able to benefit from the credit facilities provided. The rest of the community who live in the unorganised money markets are either unaware or largely unable to make use of the financial credit which most of them desperately need. As a result they find themselves exposed to money-lenders who charge exorbitant interest rates. The bulk of the farmers in the Sudan have limited access to the credit facilities provided by commercial banks and the Agricultural Bank; and in view of their low level of income – which hardly allows for a margin of savings – these farmers accept the *shail* credit. Thus, agricultural credit in the Sudan can be divided into two broad categories according to the source : the modern institutional credit and the traditional system of *shail*. The domain of the traditional system is among the subsistence farmers, and it is operated by village merchants, landowners, butchers and relatively affluent villagers. The impact of the *shail* system is marked in Northern Sudan, Eastern and Western regions and the Central Sudan, especially in the Gazera Scheme.

²¹ *Shail* system is a form of agricultural credit practised in Sudan.

There are two identified forms of *shail* in the Sudan: the oldest form, that of an advance of grain or seed valued at a price substantially above the estimated price of the next harvest. A borrower must settle the loan by returning at harvest time enough crops, to make up the money equivalent of the loan. If a good harvest follows a bad one, with a resulting drop in market price, the lender may get back as much as five to six times the goods he loaned out.

A second form of the *shail* involves the advance of money against future crops. At the beginning of the season, the farmer will request a sum of money (or sometimes consumer goods) to be repaid in a specified quantity of produce. The money-lender will set the amount to be lent against the future delivery substantially below the last harvest price or the anticipated value at the forthcoming harvest, whichever is lower. Thus, when the borrower discharges the pledged quantity of produce, the lender should derive a substantial windfall from the operation, namely the difference between the harvest value of the commodity pledged and the *shail* value set by him.

6.9.1 *Shail* system in the Gazera

In the Gazera a tenant needs credit for the production of cash and food crops, for marketing his products and for maintaining his household. The Sudan Gazera Board gives credit for cotton and wheat only. Little institutional credit is available to a tenant for the production and marketing purposes, and he is not able to obtain consumer credit from institutional sources by any means. Consequently, the tenant turns to village lenders for much of his credit needs, either for production and marketing or for consumption.

The practice of *shail* is widespread and deep rooted in the Gazera, and it is the main source of agricultural credit. The earliest record of incident of *shail* in the Gazera was during the World War II when the shortage of *dura* (sorghum) in the Gazera and the whole Sudan was partly blamed on *shail*, (F. Hassan Adam and Andrea Apaya, 1973).

The *shail* merchant in the village does not provide all the credit from his own sources, but draws from a more substantial merchant in nearby towns. These in turn acquire capital (as goods) from sources in Khartoum. As mentioned above,

the recourse of *shail* operator to other sources of finance increases his administrative costs and in turn raises his interest rates on the loaned funds.

In the Sudan an establishment of the Sudan Oilseeds Company has helped, to a limited extent, in reducing the level at which *shail* is practiced. The company lacks money and it depends on agents to buy and collect crops from farmers. The agents do practice *shail* by offering lower prices to farmers.

Tenants in the Gazera acquire *shail* credit for different agricultural operations, but the heaviest incidence of it occurs in August and September when work in the field is heavy and labour is in short supply or expensive. November and December are another heavy *shail* periods.

The prices obtained by farmers in the *shail* system are generally lower than current market prices. Table 6.6 gives the *shail* market price ratios for the three farmers groups in the sample with respect to *dura* (sorghum), wheat, groundnuts and *lubia* (cajanuscajan). The ratios for the low-income farmers are lower than for the other two groups, with regard to each crop. The average ratios also indicate that the low-income farmers have a lower price ratio. This implies that their bargaining power with the *shail* operators are weaker than the position of the middle-and-high income farmers. However, if the Sudan Oilseeds Company is provided with enough capital and if it sends its own representatives to the production areas and buys directly from farmers, it could enhance the farmers' position and the *shail* operators might disappear.

Table 6.6: *Shail* Market Price Ratios

Tenant Group	Sorghum	Wheat	Groundnuts	<i>Lubia</i>	Average*
5 - 9 <i>feddans</i>	46.2	40.0	45.2	29.1	43
10 - 19 <i>feddans</i>	48.8	44.8	55.2	42.0	49
20 <i>feddans</i> and above	62.5	-	-	-	63.3
All tenant groups	52.8	28.3	35.5	23.7	34.6

* Figures for the average are weighted.

Source: F. Hassan and Andrea Apaya, 1972.

Other forms of rural credit are practiced in the Gazera. The most common form is tenants making arrangement with merchants or butchers to sublet a portion of the tenancy to the latter. Others join in a partnership in a rotation garden with a merchant who finances the project. There may be a simple division of profits or the loan plus a substantial share of the profits may be a first charge paid to the merchant.

To conclude, it is obvious that the only source of institutional credit of importance to the tenants is that from the Sudan Gazera Board. The Sudan Gazera Board advances cashes to the tenants for sowing, weeding, harvesting and for cleaning the cotton fields. On behalf of the tenants, the Board finances land tillage by mechanical power, provides chemically-treated seeds, fertilisers, chemical spray. No interest rates are paid to the Sudan Gazera Board, only the face value is deducted. Commercial banks' credit is rarely given to the Gazera tenants. Like his counterpart in the traditional sector, the average tenant does not possess the necessary equitable assets to pledge as security for loans from commercial banks.

In order to eliminate *shail* system it is necessary to increase the actual marketable surplus out of which the farmers can pay their debts. This should be supported by efforts to raise the demand for these surpluses. The failure to grade, store and freeze together with the lack of transport facilities will tend to perpetuate narrow market conditions under which added production may only be sold at sharply falling prices.

The government needs to increase the capital of the Sudan Oilseeds Company. Moreover, it might be reasonable for the Central Bank to relax its regulations covering the provision of rediscount facilities, and this consideration should be closely examined. Commercial banks could extend production credits and even consumption credits to farmers if the government helps farmers to warehouse, grade and transport crops and if the land titles are well defined and provide a suitable collateral. The volume of cheap loan from the Agricultural Bank needs to be increased and widely dispersed.

Chapter VII

Islāmic Banks In The Sudan: Problems And Prospective Development

This chapter incorporates a number of issues concerning the problems facing IBs in the Sudan, and discusses basically their market share and, consequently, their role in monetising the economy. It may be true that IBs have been successful in mobilising resources either through paid-up capital or through deposits, but are they capable of maintaining this share? What is the nature of the deposits they mobilise; are they short-term or long-term? What is the degree of their utilisation? Are these mobilised resources available for all depositors to use in form of credit facilities? Are there problems caused by the Central Bank which hamper the IBs in their use of these resources?

The focal point is the market share of these banks and its determinants. The author assumes that there are three chief elements that affect this share directly and determine its magnitude, structure and upholding. These are: (i) customer behaviour, (ii) management behaviour; and (iii) attitude of the authorities. There is, however, another set of determinants that influence this market share. These are considered to be:

Can IBs manage to deal with interest-based banks?

How can they manage their portfolio?

What are the profit distribution methods or policies?

What are problems of management and the set-up of branches?

In fact, an examination of the market share will answer the question: do the IB contribute to economic development²² in one side, that of tapping savings and monetising the economy? This will be discussed here in this chapter. The next

²² The main theme of this work is to examine the role of IBs in economic development in the Sudan. However, it is the perception of the author that their contribution to economic development would be in broad sense, i.e. to mobilise resources on the one hand, and to allocate these resources on the other hand. Therefore the last word on this point will be in the next chapter

chapter will answer the question: do the IB contribute to economic development in its other side, that of financing medium and long-term investments? In other words, do they allocate mobilised resources efficiently and productively?

According to its objectives, this chapter will concentrate wholly on the role of IBs in absorbing financial resources and on the factors affecting this role. Hence, its sequence will be as follows:

- a general background on IBs, especially IBs in the Sudan
- their market share magnitude
- market share determinants as perceived above.

7.1 General Background:

The past two decades have witnessed important developments in the field of Islāmic banking. During the 1970's there was spectacular growth both in the number of Islāmic banks (IBs) and in the volume of their global activities. The emergence of substantial balance of payments surpluses in a number of oil-exporting Muslim countries paved the way for the formation of giant multi-national IBs and helped the spread of Islāmic banking in other Muslim and non-Muslim countries. At the time it was suggested by some financial analysts that the unprecedented surge in Islāmic banking activities was bound to be a short-lived phenomenon and that with the drying up of the oil-exporting countries' surpluses, the initial progress would not be sustained, and there would be a risk of a sudden financial collapse. Subsequent events, however, have proved them wrong. Islāmic banking is

'no longer a negligible phenomenon', (Nienhaus, Volker, 1988, p. 84).

The severe international economic recession of the early 1980's posed a real challenge to the viability of the IBs which, true enough, had grown under the favourable economic conditions of the previous decade. With the economic recession IBs came under pressure from two sides. Firstly, recession at home led to a squeeze on their sources of finance. This was particularly the case for the large multi-national banks whose main sources of finance, both in terms of share capital and deposits, came from the surplus-oil economies of the Middle East. The second

source of pressure was the squeeze on profits resulting from the slump in world trade and the decline in returns on real investment which comprised the main sphere of activity of IBs in their earlier years, (Inquiry Magazine, vol. 4, No. 11, November 1987).

Despite such pressures, IBs appear to have successfully passed through these difficult phases. Their future growth, however, depends on their ability to mobilise savings and allocate them into medium-and-long-term investments. In this regard, IBs are challenged by certain kind of constraints, namely an absence of developed money and capital markets working on an interest-free basis. In other words, the future growth of Islāmic financial institutions requires

'some financial innovations', (Nienhaus, Volker, 1988, p. 84).²³ Detailed theoretical aspects of IBs and their development have been elaborated in the preceding chapters.

7.2 Islāmic Banks in the Sudan:

Like other Islāmic financial institutions, IBs in the Sudan adopt the theoretical models of interest-free banking: they carry on their business activities on the basis of *profit-and-loss sharing (PLS)* which is permitted in Islām. Islāmic legal concepts of *muḍāraba*, *mushāraka*, *murābaha* and other forms, are translated into institutionalised banking practices. IBs in the Sudan replaced the interest rate with the rate of return on real activities, sharing risk and incentives with their clients, and have, therefore, followed the fundamental premise of Islāmic banking. They are expected, as IBs, to participate actively in achieving the goals and objectives of Islāmic economics. As a result of the spectacular growth of IBs in the 1970's, and an increase in their international activities, the concept of Islāmic banking was introduced first in the Sudan in August 1977. At that time, the Faisal Islāmic Bank (Sudan) (FIBS) was established under the *FIBS Act of the National People's Council*.

The initial success of the FIBS encouraged policy makers in the country to support the IBs movement. As a result, three other IBs opened in 1983, namely the

²³ For detailed discussion on this point see Wilson, Rodney J., *Expansion- Recent Developments and Scope for Further Financial Innovations*, Department of Economics, University of Durham, May 1988.

Tadāmon Islāmic Bank, the Sudanese Islāmic Bank and the Islāmic Co-operative Development Bank owned by Co-operative Unions. In 1984, two more IBs started operation: the Al-Baraka Bank (Sudan) and the Islāmic Bank of Western Sudan.

The former regime in the Sudan launched Islāmic *Shari'a* laws in September 1983. Following this enactment, banks were asked to change their business activities so as to be consistent with the Islāmic *Shari'a*, and in September 1984 the whole banking system was Islamised by a presidential decree. However, in practice, managements of the originally non-Islāmic banks did not apply Islāmic modes of operation properly since they were unsatisfied with the viability and feasibility of these kinds of modes. The Islamised banks applied *muḍāraba*, *mushāraka* and *murābaha* only formally in their ledger books and in reports submitted to the Central Bank. Moreover, even the policy makers in the Central Bank of Sudan were, as well, discontented with the procedures for transforming the banking system. They considered it as a mere political decision imposed by the government without being preceded by adequately detailed and deeply rooted studies. In 1985, the regime was overthrown and many Islamised banks neglected Islāmic modes of operating much more than they had.

Like their counterparts in other countries, IBs in the Sudan were affected greatly by the regulatory measures imposed. These were first enacted by introducing a special law²⁴ exempting them from a number of existing banking rules. After Islamising the banking system, the authorities withdrew all the concessions. Unfortunately, after a number of years of operation, the relationship between IBs and the central bank still remains unstable, and the latter sought to regulate their activities and resorted to the legislative authorities to bring them under control. Effectively, these regulations hampered the development of IBs, which were also affected by the press campaign against IBs internationally and in the Sudan, particularly after 1984.

In the Sudan there existed for a long time a system of lending to farmers which is even worse than interest lending in terms of the extravagant interest rates that are usually charged, (see chapter six). The system of '*shail*' has survived for quite a long time despite its prohibition by the *shari'a*. Therefore the major role

²⁴ See the chapter on FIBS.

assigned for IBs is that they should eliminate this informal sector by extending their banking services and credit to a large number of the population, especially in the rural areas.

7.3 IBs as Contributors to Development:

The quantitative expansion of Islāmic banking could do more than merely passively permit the growth of the real economy. Financial growth of IBs could be an active contributor to more rapid real economic growth. Active contribution can take two forms: (a) increasing the productivity of existing capital and (b) raising the supply of savings.

7.3.1 Increasing the productivity of capital:

The most significant improvement in the productivity of existing capital could come about if IBs (as well as for other commercial banks) use to provide liquidity through transactions balances as a substitute for barter. When used as a medium of payment, commodities have several disadvantages, being costly and risky to transport from place to place, or to store away as a form of wealth. In the Sudan, commodity barter is already limited to remote rural areas. This is fortunate given that commodities represent idle capital and seem to earn no return for their owners. Banking money, by contrast, costs almost nothing to produce and (through loans) represents savings put to work; it is active capital. With the spread of IBs in rural areas, the use of bank intermediation may be expected to displace commodity barter and thus enhance the productivity of the society's existing real capital. When these commodities (including gold) are drawn from the private hoards of planters and merchants and transferred to bank vaults, they serve more productively as 'high powered' reserves rather than as 'low-powered' money in circulation. The IBs have a favourable record in this respect, for they have attracted new (petty) savers into the banking cycle; however, their role in rural areas is still limited (see below).

Expansion of IBs could also enhance the productivity of existing physical and human capital. By improving access to equipment and markets, IBs credit could enable those in traditional sectors to give up subsistence-oriented agriculture in

favour of more profitable crops. At a slightly more advanced stage of development, external finance (by IBs) sometimes permits a planter to change from the less productive to the more productive practices. This may involve more capital-intensivity, or the adoption of a more efficient technology. In such cases the land, labour and other forms of capital can gain in productivity. Here, IBs have started to finance small farmers and handicrafts. The Sudanese Islāmic Bank is now funding small planters to produce cash crops, but the attempt has only just begun and is limited mostly to urban areas. The Faisal Islāmic Bank of Sudan is participating in one of the agricultural schemes, which is using capital-intensive techniques; it is also funding small handi-crafts.

To summarise, IBs are required to participate more in improving the productivity of the existing capital by extending their services, especially to the rural areas, and by improving access to equipment and markets by extending funds to those in traditional sectors to finance more productive inputs.

7.3.2 Raising the supply of savings:

The contribution of IBs to economic development is measured not only by increasing the productivity of capital, or allocating resources to productive sectors; it is important also to examine their size in relation to the banking system and the economy as a whole, i.e., the size of resources they can mobilise and their capability to raise the supply of these savings. One point will be elaborated upon in this regard, namely the role of IBs in monetising the economy.

7.3.2.1 Monetising the economy

- **IBs' density**

Increasing the supply of savings depends on the degree of monetisation of the economy. IBs have a role to play in a country like the Sudan, where the traditional sector is still dominant. This role depends on their expansion and spread in the rural areas instead of concentrating in urban areas. Expansion is important for economic development in terms of reducing costs of borrowing.

Therefore, IBs' density (i.e. spread) is significant primarily in terms of their accessibility. The larger the proportion of the population which have access to bank

facilities (and the larger the share of financial assets passing through the hands of bankers), the more effectively the banking system can discharge its functions.

Density can be measured in various ways. These include the number of offices per unit of area or per number of inhabitants. However, this method of measuring density is by itself inadequate because the number of offices per unit of area or inhabitants says little about the volume of bank resources available to the area and its inhabitants.

The simplest measure of the degree of banking spread is one which relates the number of branches to area. A somewhat more significant measure of density relates banks' offices to total population. The actual index used here is constructed as follows:

$$\frac{\text{Number of offices} \times 10,000}{\text{total population}}$$

A ratio over 1.0 - i.e. more than one branch per 10000 inhabitants - is 'high'. A ratio between 0.5 and 1.0 is 'moderate', whereas one below 0.5 is 'low'. A ratio less than 0.1 is 'very low', (Cameron, R., 1967).

Table 7.1 shows the spread of banking branches by region. IBs branches constitute 25.8% of the banking system branches, which indicates the importance of IBs. Both IBs and the commercial banks have the same degree of concentration in the urban area of Khartoum. The banking system is concentrated more in the Central Region and the Southern Region. Apart from that, IBs predominate the backward rural regions more than in other regions. This might signify their contribution to monetising the traditional sector and would, therefore, have a favourable impact on economic growth.

It is, in fact, a favourable indication of their contribution to economic development that IBs have spread to the rural areas. But this is not to say that they have developed the 'banking habit' to such a high degree that individual savers can be attracted increasingly to holding their savings in financial rather than real form. The consequence of this can be observed in backward regions such as Darfor and Kordufan, where the general public still makes relatively infrequent use of cheques.

Taking the more appropriate banking density measure – i.e. the actual index–, banking density in Khartoum is *moderate*, between 1.0 and 0.5, and it is *low* for the Central, the Northern and the Eastern Regions, being less than 0.5. More important, it is *very low* for the most backward regions of Darfor, Kordufan and the Southern Regions, being less than 0.1. This is the finding for all banks and can be generalised for IBs as well. Thus, one may conclude that IBs still have a *very low* density, especially in the more backward regions.

In this respect, the purpose of IBs, as financial institutions in an under-developed economy, would be to provide collecting points for savings of a relatively small average amount from a large number of individual sources. So long as the means to utilise savings safely and profitably are not available in remote rural areas, funds will either be sterilised in useless hoards of cash or precious metals, or, more likely still, will not accumulate at all, (Navin, E., 1961). Since the Sudan is a poor country, there is a great need for IBs and for other financial agencies to collect and invest the savings of the people and institutions within its borders.

Table 7.1: Banks' Density by Regions

Regions	Branches by region					population	Bank density
	all banks (1)		IBs (2)		2/1	(million)	
	number	%	number	%			
Khartoum	96	33.9	25	34.2	26.0	1.802	0.53
Central	60	21.1	10	13.7	16.6	4.026	0.15
North	27	9.5	12	16.4	44.0	1.074	0.25
East	44	15.5	12	16.4	27.2	2.208	0.20
Kurdofan	24	8.5	01	11	04.0	3.093	0.08
Darfor	15	5.3	05	07	33.3	3.094	0.05
South	17	6.1	08	1.3	47.0	5.271	0.03
Total(1987)	283	100.0	73	100.0	25.8	-	-

Source: Bank of Sudan Reports; IBs' Reports; Department of Statistics

However it is not enough just to extend services to rural areas, mobilising savings there and placing them in investment activities outside these rural areas.

Not only should the spread of IBs improve the interregional flows of funds, it should also reduce the disparities in the cost of borrowing, and invest the mobilised resources in the rural areas. IBs managers have indicated that they use deposits of branches in rural areas in one way or another to fund investments in urban areas. This 'export' of rural area savings will have an adverse effect on the growth rates of these backward areas. In this respect, one might argue that IBs should adopt a *growth-from-below* policy, with more emphasis on the financing of small-scale economic activity in industry and agriculture. They should open branches in rural areas so that every branch could carry out specific functions and thus activate stagnant potentialities for growth. This *growth-from-below* policy should be through the branch banking expansion rather than unit banking expansion. Branch banking has the advantage of widening the resource base which enables sudden emergencies to be dealt with more easily, diversifying their risks to a greater extent. Hence IBs could be less susceptible to difficulties. The expansion of branch banking can also enable IBs to shift resources geographically with greater ease and less cost, which in turn can help to equalize rates of returns on capital in different regions and industries.

IBs face the challenge of finding ways in which their system can interact with a traditional banking system dominated by *riba*, without themselves being committed to interest-bearing dealings. The question is: What is the size of IBs' deposits and what are the determinants of this market share?

7.4 Market Share Magnitude:

The market share is meant here to include the paid-up capital and deposits of IBs as compared to that of the banking system as a whole. Below is an examination of the volume of the paid-up capital, and the size of deposits and their components.

7.4.1 Paid-up capital

7.4.1.1 IBs and commercial banks:

IBs' paid-up capital, as a percentage of that of commercial banks, increased from 9% in 1980 to 51% in 1985, falling slightly in the years 1986 and 1987. However, this fall was not significant as it was attributed partly to a re-valuation

of paid-up capital of some foreign banks whose capital is in foreign currency, (Table 7.2 and Figure 7.1(a))

Table 7.2: IBs & Banking System: Paid-up Capital (1980-1988) (LS. million)

	IBs (1)	<i>Bankingsystem</i> * (2)	<i>Bankingsystem</i> * (3)	(1)/(2) %	(1)/(3) %
1980	5.6	65.8	60.2	9	9.3
1981	11.3	73.3	62.0	15	18.2
1982	14.7	94.4	79.7	16	18.4
1983	70.1	246.7	176.6	28	40
1984	154.8	328	159.7	51	105
1985	168.3	328	159.7	51	105
1986	175	425.6	250.6	41	70
1987	178	466.5	288.5	38	62
Total	777.8	2026.3	1248.5	38.4	62.3
<i>R</i> [†] %	62	38	14	-	-

* Including IBs.; * Excluding IBs.

†Growth rate, as calculated by the author.

Source: Economic Survey, Ministry of Finance, IBs Reports

More importantly, IBs' paid-up capital grew at faster rate than that of the commercial banks. The former grew at 62% while the latter grew at 38% over the period under review. However, when excluding IBs, other commercial banks grew at 14% . This implies that IBs boosted the growth of the banking sector in terms of increasing the paid-up capital; they therefore have played a significant role in monetising the economy.

7.4.1.2 IBs and joint banks

There are eleven joint banks working in the Sudan, six of which are IBs. It is clear enough that IBs have the lion's share of paid-up capital of these banks, to the extent that in 1985, 83% of these banks' paid-up capital was that of IBs, (see Table 7.3 and Figure 7.1(b)).

Moreover, the growth rate of paid-up capital of the IBs was 18.8% while that of all joint banks was 22.6% over the period 1983-1987. Thus an introduction of

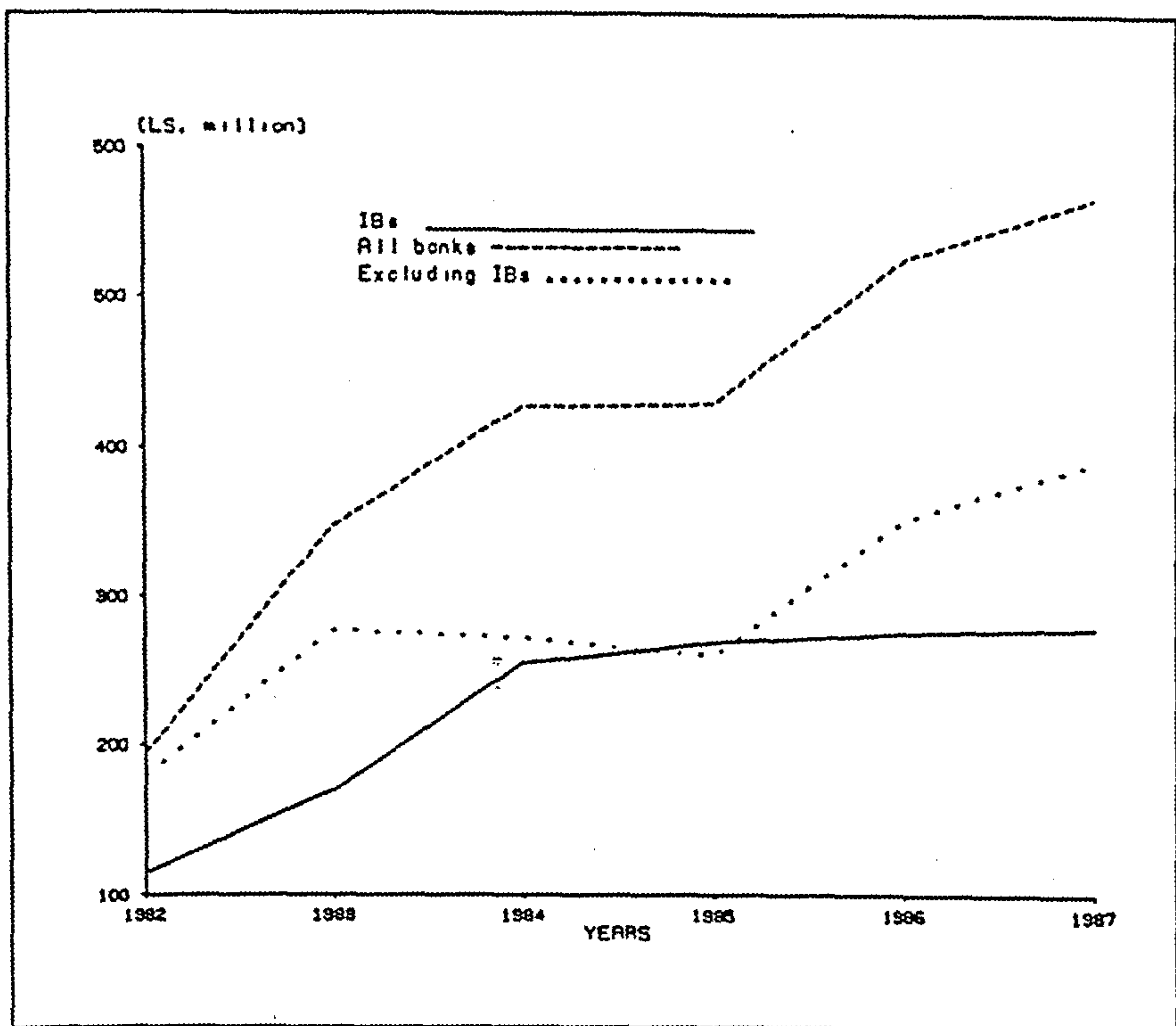


Figure 7.1(a): IBs & Banking System Paid-up Capital

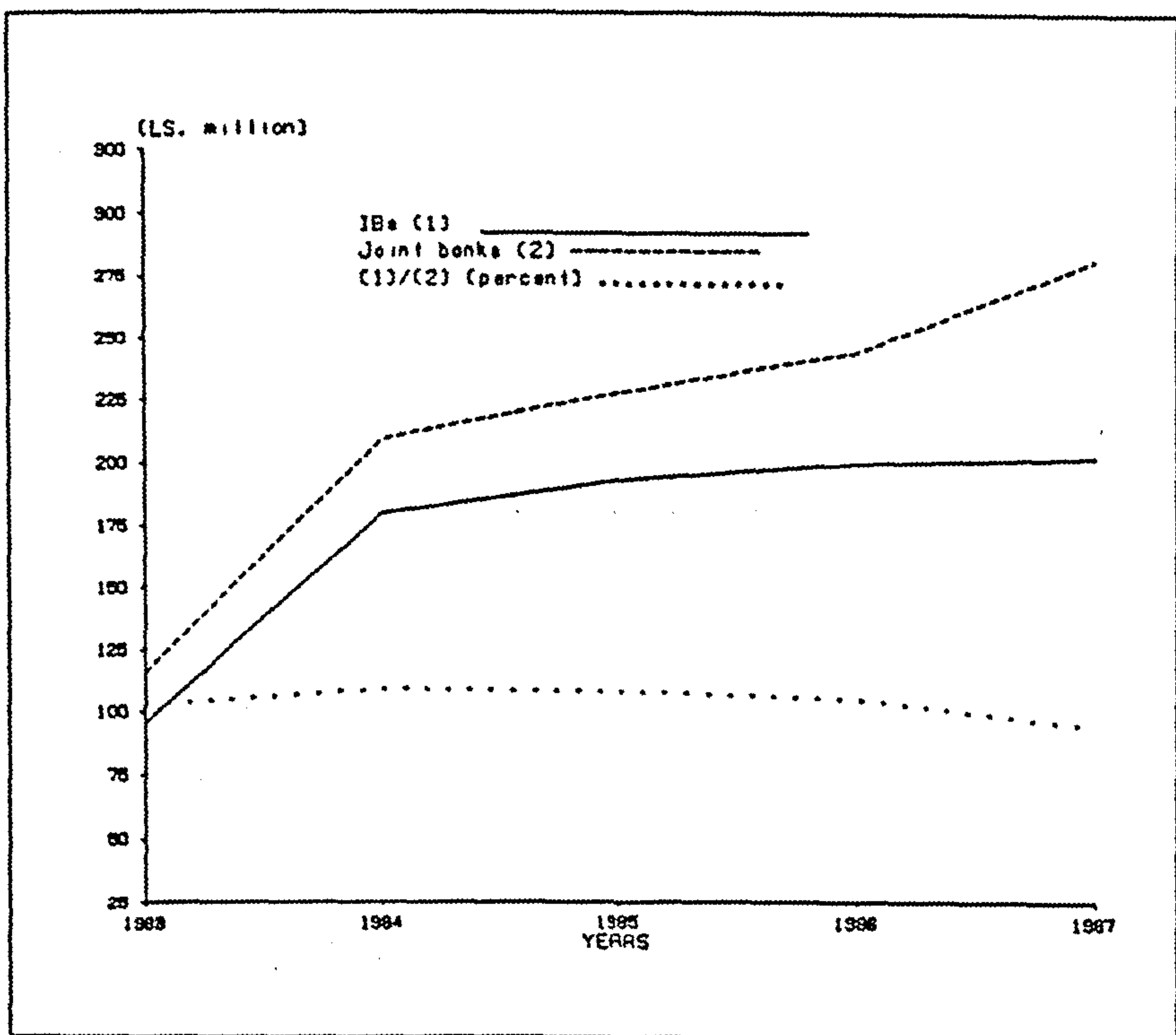


Figure 7.1(b): IBs & Joint Banks Paid-up Capital

Source: Derived from Table 7.2

IBs as a joint-venture between Sudanese nationals and foreign subscribers has been beneficial to the economy, since the experience of introducing IBs attracted foreign resources and mobilised the stagnant local resources.

Table 7.3: IBs & Joint Banks Paid-up Capital (1983*/1987) (LS. million)

	IBs (1)	All joint banks (2)	(1)/(2) %
1983	70.1	90.7	77.3
1984	154.8	184.4	84
1985	168.3	203	83
1986	175	219.5	80
1987	178	256.3	69.4
Total	746.2	953.9	78.2
R	18.8	22.6	-

* Most of joint banks started operation in 1982.

Source: Ibid

IBs are characterised by a relatively high degree of capitalisation compared with other commercial banks. What then is their share in the deposit market?

7.4.2 Deposits

Commercial banks usually use both paid-up capital and deposits in carrying out their business. Therefore, it is important to see the size of deposits. Table 7.4 below (and Figure 7.2) shows deposits for IBs and the banking system for the period 1980-1987.

Firstly, IB deposits, as a percentage of commercial banks' deposits, increased successively from only 7% in 1980 to 11% in 1981, 15% in 1982 and 18% in 1983. It then began to fluctuate, but remained at a level of 18% in 1987. The annual percentage change of IB deposits was higher in the early years, but declined later, particularly in 1984-85 when the annual change was only 4%. Commercial banks' percentage change increased steadily up to 1985.

Secondly, the growth rate of IB deposits exceeded that of commercial banks. Deposits of the former grew by 42% while those of the latter grew by 30% over the same period under review.

Table 7.4: IBs & Banking System Deposits, (1980-1987) (LS. million)

	1980	1981	1982	1983	1984	1985	1986	1987
Banking system (1)	720	943	1340	1781	2064	3623	4243	5786
Annual change (%)	-	31	42	33	76	76	17	36
IBs (2)	50	102	202	318	596	619	763	1044
Annual change (%)	-	104	98	57	33	4	23	37
(2)/(1) %	7	11	15	18	16	17	18	18
$R_{BS} = 0.30; R_{IBs} = 0.42$								

Source: Commercial Banks Reports; Sudanese Islāmic Banks, Facts and Figures

Therefore one would say that IBs have a relatively good market share. They can claim nearly two-fifths (38.4%) of banking system paid-up capital and one-fifth (18%) of deposits. This is in general a good market share for the IBs to maintain, let alone an efficient allocation of resources. The question of upholding the market share is discussed below within the context of its perceived determinants.

(A.) Market share: chief determinants

Given the size of the market share of IBs and its structure, what then are the determinants which affect the maintenance of this share? There are three factors perceived to have an impact on both the market share magnitude and its form. These are: (1) the relationship between banks and their customers, which referred to here as customer (depositor) behaviour; (2) managers' efforts to raise and encourage savings, referred to here as management behaviour; and (3) the relationship between banks and monetary (and financial) authorities, referred to here as public authorities attitude.

7.5 Customer Behaviour

An analysis of this factor is the result of a fieldwork done in Sudan during the period February-April 1989. The aim of the questionnaire is to evaluate the role of

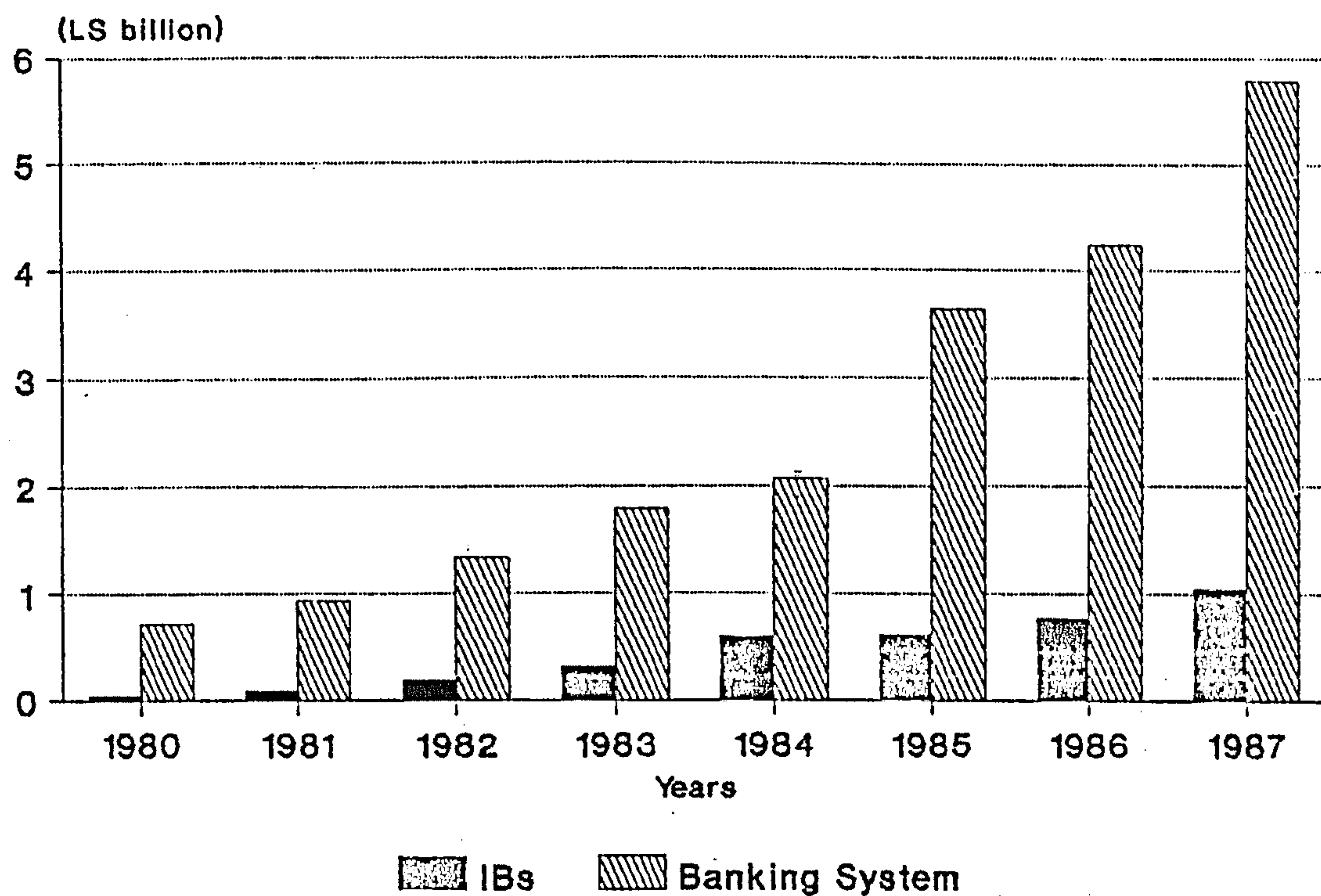


Figure 7.2: IBs & Banking System Deposits

Source: Derived from Table 7.4

the IBs in mobilising savings. Accordingly, the questions that would be included in a questionnaire of depositors would be expected to cover points such as: To what extent did IBs attract new funds and help in extending banking services, especially in rural areas; to what extent did the activities of IBs complement those of conventional banks; did some depositors use both types of banks or did IBs attract new categories of clients? The questionnaire was addressed to the depositors.

7.5.1 Depositors: sampling and characteristics

7.5.1.1 Piloting the questionnaire

(a) Structure and comment:

The structure of the depositors questionnaire was intended to be flexible, sim-

ple and straightforward, since as depositors may be illiterate. The questionnaire was thus first structured then commented on by some colleagues who were studying the relevant subject, and then revised again by the supervisor. There was a room left for changes expected to be done by managers of IBs. Fortunately, however, they made only minor amendments. Generally, the questions were all closed sure for the last one where depositors were allowed to comment if necessary.

(b) Pre-testing:

Before actual administration, the questionnaire was pre-tested by ten depositors with IBs whom the author knows personally. Pre-testing was intended to reveal the practicality of the questionnaire and the time it might take to fill in. The average time was found to be fifteen minutes. Pre-testing was useful since it uncovered the fact that depositors did not like to disclose or give information on their deposit size. They were either uncertain about it or, as in most cases, refrained deliberately from giving information. Consequently, the question regarding deposit size was cancelled.

7.5.1.2 Population and sample (characteristics)

(a) Total and sampled population:

The target population consists in IB depositors. In fact, there were difficulties encountered in reaching depositors in rural areas, difficulties attributed to the inability of transport to get through to rural and remote areas where bank branches are found, plus the time constraint. Therefore, the total population was sampled so that the sampled population comprises IB depositors in the capital, Khartoum.²⁵

(b) The sample:²⁶

The sample size was calculated as follows:

$$d = \sqrt{\frac{\sigma(1-\sigma)}{n}} \quad \text{and therefore,}$$

$$n = \frac{\sigma(1-\sigma)}{d^2}$$

²⁵ Great Khartoum is actually three big cities, Central Khartoum, Khartoum North and Omdurman.

²⁶ See Moses, C. A., (1965), *Survey Methods in Social Investigation*, London, Heinemann, Educational Books, p. 116.

where:

d = the margin of sampling error that is tolerated.

σ = the proportion with the particular attribute in the population. d can be estimated using a pilot survey.

n = sample size.

Depositors of IBs in urban areas represent the particular attribute in the population which was the basis for calculating the sample size. The author was unable to obtain certain figures on the number of depositors with IBs or their distribution between rural and urban areas. However, because of the relatively heavy concentration of banking activity in urban areas, the 'sampled population' was expected to be large as a proportion of 'total population', not less than 60%; therefore the proportion was (using a pilot survey) around 65%.

The margin of sampling error tolerated was 3%. Accordingly the sample size was calculated as:

$$n = \frac{0.65(1-0.65)}{(0.03)^2} = 252$$

The total number of questionnaire forms distributed was 300. The actual number collected was 205. Seven of the forms filled in by depositors were either incomplete or inconsistent. The net outcome of the sample size was 198.

(c) Method of selecting a sample:

The method used in selecting our sample was *simple random sampling*, in which each of members of the population has an equal chance of being chosen. To increase its adequacy, *random sampling* was stratified so that our sample is a *stratified random sample*. The process was as follows:

Firstly, the sampled population (depositors in urban areas) were stratified into sub-population, which was taken here to be depositors with branches of IBs in the three towns which make up Khartoum: Central Khartoum, Khartoum North and Omdurman.

Secondly, each *strata* (or sub-group) was sampled so that names of depositors were chosen. The method of *stratification* still assures that each item in the population has a chance of being chosen in the sample.

(d) Administration of the questionnaire:

The total number of questionnaire forms distributed was 300 as mentioned above. It was administered as follows:

75 forms were given by the author directly to the chosen depositors,

95 forms were filled in by chosen depositors with the help of bankers (junior employees) at the counters of IBs.

28 were filled in by depositors with the help of branch managers.

(e) Depositors classes:

At the pre-testing stage, as seen before, depositors refrained from giving information on the size of their deposits. For this reason, the completed forms were collected and given to branch managers to classify depositors according to the size of deposits they have; (Table 7.5 below).

Table 7.5: Depositors' Classes

Class limit (deposit size LS 000)	1 - 10	11 - 20	above 20	Total
No. of depositors*	84	59	42	185
	45.1%	32%	22.9%	100

* Holders of current accounts only.

Source: Depositors Survey.

The classification was done for those holding current accounts (185 depositors) and without mentioning names of depositors. According to their experience, branch managers classified the size of deposits as: (a) from LS 1000 to LS 10000 a small deposit, (b) between LS 11000 and LS 20000 a medium-sized deposit and (c) above LS 20000 a first class account. Depositors were found to be distributed among these groups as shown by Table 7.5 above.

(f) Distribution of depositors among banks:

When the questionnaire forms were first distributed, the intention was to consider the estimated number of IBs depositors so that a bank such as FIBS would be given more weight. In actual fact, this was the result for FIBS and Taḍāmon Islāmic Bank only. For other banks, the number of depositors who responded and returned their forms was not in proportion to a number of bank depositors. The distribution of those banks who were addressed is:

Table 7.6: Depositors among Banks

Name of a bank	Number of addressed depositors	percent
Al Baraka Bank	10	5.1
Islāmic Co-operative Development Bank	13	6.6
Islāmic Bank for Western Sudan	15	7.6
Sudanese Islāmic Bank	20	10.1
Taḍāmon Islāmic Bank	50	25.3
FIBS	90	45.5
Total	198	100

Source: Depositors Survey, 1989.

(g) Difficulties and short-comings:

The purpose of the survey is to examine the role of the IBs in expanding banking services, mobilising savings – especially petty savings in rural areas –, and to see whether depositors have more access to banking credit facilities. Rural depositors were not addressed for the following reasons:

(1) It was physically difficult to reach depositors in rural areas because these areas are far from the capital and access was quite difficult;

(2) To contact depositors there, would be time-consuming, and the cost is prohibitive.

The fact that only depositors in urban areas were addressed may be seen as a short-coming. Even then, it is certain that some of the depositors who were addressed in urban areas were actually from rural areas.

Another type of difficulty was that some depositors took the forms but did not complete or return them: out of 300 questionnaire forms distributed, only 205 were filled in.

The actual number of customers addressed was less than the calculated sample size. Moreover, unwillingness and negligence on the part of some depositors resulted in seven incomplete and unclear forms, reducing the sample size to 198.

7.5.2 An analysis of survey results

The question now rises: Could IBs maintain their deposit market share provided that they continue managing deposits at their disposal on a *PLS* basis? This depends to a great extent on their relationship with their customers. At this level, an answer to such an important question might be approached by examining the attitude of customers (depositors).²⁷ Depositors were thus asked to answer questions about, (i) their motives in dealing with IBs; (ii) their choice from different accounts; and (iii) their views about the level at which IBs are extending services.

Discussion of the research findings aims at establishing whether IBs attract new depositors into banking circles and defining the exact nature of a relationship between depositors and the banks. There now follows, an analysis of the role of IBs in attracting new customers. Customer behaviour, as a factor affecting the market share will be explored via: customers' motives and preferences, their attitude towards investment account and their views regarding the level of services extended.

7.5.2.1 Attracting new depositors

Did IBs attract new depositors to banking business, i.e. those who might in the past have eschewed dealings with banks on religious grounds or purely through unfamiliarity?

²⁷ A different set of questions was answered by IB managers to gauge their efforts towards maintaining the bank-customer relationship. This will come later.

In order to answer this question, customers were asked to indicate if, in addition to their dealing with IBs, they were involved with conventional banks in any sort of banking business. In particular, did they have accounts with conventional banks?

Of the 198 depositors, 70 had accounts with both traditional banks and IBs, i.e. 35.4%. 64.6% (128 depositors) had been prompted to establish bank relations for the first time by IBs.

This is a positive sign of contribution to monetisation, but it should not be taken for granted. The reason is that, those with accounts with traditional banks and IBs were asked to show whether their dealings with the former preceded or followed those with the latter. 60 out of 70 depositors, stated that they dealt first with conventional banks. But it still remains to the credit of the IBs that they attracted not only new depositors, but even those who had already been customers of traditional banks.

7.5.2.2 Depositors: low and high-income groups

A contribution which could be attributed to IBs was that they attracted not only new depositors, but small depositors as well. This finding was evident from the distribution of depositors according to the deposit size.

Out of 185 customers holding current accounts, 84 (45.4) were low-income depositors, 59 (32%) middle-income depositors, and 42 (22%) high-income depositors (vide supra).

As seen above, there were 70 depositors who dealt first with conventional banks before having any relation with IBs. What was noticed is that 38 depositors (54.3%) were from the high-income group; 20 (28.6%) were from the middle-income group; and only 12 (17.1) were low-income depositors. Thus one could say that conventional banks, as compared with IBs, are used to dealing with high-income groups of customers rather with those from the low-income group. This provides evidence for the above statement that IBs attracted new depositors to the banking system, and in particular low-income depositors. Of course it is not enough only to attract these petty savers; the question is, 'Do they have access to get credit facilities compared to high-income group depositors?' This will be answered latter

when discussing customers' motives in dealing with IBs and the types of services customers use (vide infra).

7.5.2.3 Customer motives and preferences:

(a) Frequency distribution analysis:

(i) Motives:

The problem of maintaining the market share raises the question of customer motives in dealing with IBs. As a rule, there are certain motives that move customers to any type of bank, be it Islāmic or conventional: the good service; bank credit; wide spread of banking services – all these attract customers to the bank. However for IBs there is, in addition to these, a religious motive that prompts customers to deal with IBs, and this is especially important in the case of IBs in the Sudan, where the majority of people in the past abstained from banking on religious grounds.

To test the impact of customer motives on their relation with IBs, the following objectives were listed in the questionnaire and depositors were asked to show the causes that allow them to deal with IBs: (1) religious reasons; (2) high return on investment deposits; (3) increased access to bank credit facilities; (4) competitive services; and (5) the spread of bank services.

To see the effect of each of these factors, depositors were asked to indicate only two motives for their dealings with IBs. The SPSSX Programme was run, yielding the results shown on Table 7.7.

The revealed responses, (see Table 7.7 below), show that the main factor behind customer dealing with IBs is the religious factor. Then comes the competitive service factor, the widespread of services, and greater access to bank facilities. The least important factor is the rate of return.

Religious reasons are the dominant motive for depositors. This implies that IBs have convinced this sect of depositors to deal with banking, who in the past refrained from doing so because banks are interest-based. The dependence of IBs on this religiously-motivated section of depositors is crucial for them if they are to

continue supporting their market share. Serious problems would arise if, however unlikely, a majority of depositors were to change their mind and decide to disregard the religious factor, or, more importantly, if all banks began to work on interest-free basis.

Table 7.7: Depositors' Responses: Ranking of Motives

Motive	Frequency	Valid percent	Rank
Religious element	149	38.6	I
Competitive services	98	25.4	II
Widespread of services	56	14.5	III
More access to credit facilities	49	12.7	IV
High return	16	4	V
Total	386	100	-

Source: Depositors Survey, 1989.

The second, most important factor for depositors is the competitive service extended by IBs. 98 depositors (25.4%) indicated that the high quality of services offered by IBs was instrumental in their decision to deal with IBs, a result which shows that IBs are relatively competitive in extending services compared to other banks. This fact was proved elsewhere by depositors when they were asked again to show the level of services by IBs. Only 5 depositors (2.5%) said that services were *bad*, 41 (20.7%) said services were *fair*, 97 (49%) replied that they were *good* and 55 (27.8%) thought that services were *very good*. Thus over 75% of depositors were satisfied with the level of services offered by IBs and that these banks are competitive.²⁸

The spatial reason (wide spread of bank services) is the third most important factor for depositors. It means that the density of IBs is relatively higher than that of other banks (see next chapter). If, as usual, banking services are easily accessible to depositors, the number of customers who deal with the bank in question increases.

²⁸ Competitiveness was meant here to imply that depositors do not encounter delays in, for instance, depositing or withdrawing money, or in handling other banking services.

Therefore, the bank-customer relationship in the case of IBs depends predominantly on three factors: religious considerations, competitive services, and the relatively wide spread of these services. Few customers come to these banks solely for credit facilities or for high returns. The responses of the depositors revealed that only 12.7% came to deal with IBs in order to obtain credit facilities, while only 4% deal with IBs for the high rate of return on investment deposits. This finding may indicate that IBs still extend less credits compared with other banks, and also that the return on investment deposits are still low.

The lower amount of credits extended by IBs might be attributable to their lack of experience compared with other banks. Thus the number of depositors who come to IBs for credit facilities is still small, and in this regard IBs are required to adopt credit facility policies which are flexible, convenient and simple. It is also a fact that the rate of return is still not attractive enough to prompt customers to deal with IBs primarily for this purpose. In fact all rates of return, including interest rates, were not high enough to attract depositors either for IBs or conventional banks. Furthermore, rates of return were negative in real terms because inflation is high.

Consequently one is able to say that IBs now maintain their market share thanks to, religious considerations, to the competitive service they provide and, to the wide spread of services relative to conventional banks.

The first reason is peculiar to IBs: that customers deal with these banks since they do not charge or give interest. The second and third reasons are economic ones, and IBs should do more to enhance their good reputation in this respect. But the bank-customer relationship of IBs and, consequently, their market share, might be endangered if they do not attract more customers through extending a wide range of credit facilities and realising high returns on investment deposits. The responses of depositors on these two motives showed that these factors are still less attractive to depositors.

(ii) Preferred accounts:

The link between banks and their customers might be reflected by the types of accounts depositors have. There are three types of accounts: a current account in

local or foreign currency, or both; a savings account also in either local or foreign or both and an investment account. Depositors were asked to indicate the types of accounts they hold with IBs, and their preferences are displayed in Table 7.8.

It is clear that the majority of customers hold current accounts. However, what is worthy of note here is the fact that the share of investment accounts is low when seen against the total distribution of accounts. The small share of investment account implies that still IBs have not been attractive to customers to this account either because of the uncertainty surrounding the guarantee of the value of deposits or the guarantee of a fixed (certain) rate of return, or because of the low return on investment deposits.

Table 7.8: Depositors' Preference of Account

Type of account	Local (L)	Foreign (F)	L& F	Total	%
Current	137	13	35	185	75.2
Saving	29	3	2	34	13.8
Investment	19	7	1	27	11
Total	185	23	38	246*	100

* Some depositors have more than one account; thus the total is 246 and not 198.

Source: Depositors Survey.

If this small share is attributed to the low return, this confirms the above finding that fewer customers came to IBs for return on deposits, a motive which was found (*vide supra*) to be the least attractive factor to depositors. If, on the other hand, the small share of investment deposits is attributed to the risk element involved in investment accounts, this possibility would be tested (*vide infra*) using more indicative statistical methods.

So far, what has been stated above shows the strength of impact of each motive on the bank-customer relationship depending on frequency distribution analysis. It also shows the preference by customers for different accounts. This may not be enough to disclose the effect of each motive on the bank-customer relationship since frequency distribution is descriptive statistics. To test the exact effect of these motives as determinants of this relationship, another method of statistical

analysis, crosstabulation, was used here. Crosstabulation is, in short, a statistical method, using the SPSSX programme, of finding associations between variables. More precisely, it is a way of finding out chi-square values, since chi-square test is a technique for discovering whether there is a relationship between two or more than two nominal- level variables, (Susan H. Gray, 1983).

(b) Crosstabulation analysis:

(i) Motives by preferred accounts:

To examine closely the effect of clients' motives on their relations with banks, their revealed responses were crosstabulated by their preferences for different accounts. Then the motives were crosstabulated by the types of accounts that depositors hold, the SPSSX programme gives different results for different accounts. The aim here is to scrutinise the strength of each motive, compared with the others, on the choice of accounts by customers, and, hence, on the bank-customer relationship. Each account was crosstabulated with the relevant motives that might affect it. The following tests were carried out using chi-square tests by running the SPSSX programme.

(I). Current account:

For current accounts, the assumption is that the following motives determine the decision of depositors to deal with IBs: (1) religious reasons, (2) great access to use bank facilities, (3) competitive service and (4) wide spread of services. These responses were crosstabulated by responses for preference of the current account as shown on Table Crosstabulation (A).

The hypothesis testing steps were set up in the usual manner:

- The null hypothesis is that there is an equal impact for each motive on the decision to choose a current account. That is to say, the religious reason, for instance, is not a more powerful determinant in the decision of depositors (as shown by frequency distribution analysis) to deal with IBs, and in this case to have current account. (χ^2 is not larger than would be expected by chance).

- The alternative (or research) hypothesis is that the impact of motives is not equal for all motives, (χ^2 is larger than would be expected by chance).

Crosstabulation (A): motives by current account preference

	Motives			
	religious	access for credit	competitiveness	widespread
current account	139 (82.75)*	45 (82.75)	93 (82.75)	54 (82.75)

* Expected frequencies.

Chi-square (χ^2) values are:

a. 66.7 for all motives, degree of freedom (df) equal 3

b. 37.44 for religious element and wide spread of services only, df = 1

c. 9.12 for religious element and competitive services only, df = 1

- the test statistics is the chi-square one variable test.

- the significance levels of 0.05 and 0.01 would be chosen.

- the sampling distribution is the chi-square distribution.

- the degrees of freedom (df) are the number of categories minus one, in this case the df = 4-1 = 3.

- the critical (tabulated) value(s) with which our calculated (χ^2) value(s) will be compared is looked up on the chi-square distribution table according to the significance level selected and the df.

- expected frequencies in this case are equal for all categories - equal the sum of observed frequencies divided by the number of categories.

• First: for all motives

Comparing the calculated value of χ^2 ($\chi^2 = 66.7$) to the tabulated values (= 7.815; 11.314) at 0.05 and 0.01 levels of significance. Since the calculated value is higher than the tabulated values ($66.7 > 7.815$, $66.7 > 11.314$) the decision to be made is to reject our null hypothesis that motives have equal impact (on current account) and accept our research hypothesis. The conclusion is that the effect of

motives on current account is not equal and that the religious motive is stronger than others.

- Second, the religious motive and wide spread of services:

Even if only the religious cause and the wide spread of services were taken, the statistics show that their impact is different, rejecting the null hypothesis, and that the religious motive is dominant. Here, $\chi^2 = 37.44 > 3.841$ and 10.827 at 0.05 and 0.01 significance levels with $df = 1$.

- Third, the religious element and competitive services:

It was shown earlier with the frequency distribution analysis that the competitive service motive is second in importance for depositors, ranked next to the religious reason. Therefore although the null hypothesis about the impact of these two elements is to be rejected at 0.05 and 0.01 significance levels ($\chi^2 = 9.12 > 3.482$ and 6.635), it is to be accepted at 0.001 level of significance ($\chi^2 < 10.827$) implying that their impact is nearly equal. But it still remains a fact that the impact of the religious motive is greater than that of other motives, even for current account.

(II). Saving account:

The frequency distribution of revealed responses of depositors shows that the majority of depositors deal with IBs for religious purposes (Table 7.6). Moreover, even for the preference among different accounts, the religious motive is the determining factor. The statistical test above showed that even for current accounts, the religious motive was strong compared with those motives which affect depositors decision to open a current account (table of crosstabulation (A)).

The factors expected to affect the decision of depositors to choose a savings account are: (1) religious reasons, (2) competitive services and (3) the wide spread of bank services (bank density).

Responses regarding the impact of these three elements indicate that depositors held these accounts for religious motives rather than for other reasons. What is, then, the finding for chi-square tests?

Constructing assumptions:

- The null hypothesis should state that the variables are unrelated or independent of one another, so that the savings account is not affected by the above motives. In other words, motives have the same impact on savings account holdings, (χ^2 is not larger than would be expected by chance.)
- The alternative hypothesis should state that the variables are related or dependent (i.e. motives affect saving account holding) and that the religious motive is significant, (χ^2 is larger than would be expected by chance).

Crosstabulation results were shown below as:

Crosstabulation (B): motives by saving account preference

account	Motives		
	religious	competitiveness	widespread
saving	26 (18.6)*	20 (18.6)	10 (18.6)

* Expected frequencies; $\chi^2 = 7.03$; $df = 2$

Tabulated (critical) values: 5.991 and 9.21 at 0.05 and 0.01 probability levels.

Compare 7.03 (calculated value) to the critical values at different probability levels. Since the calculated value is higher than the the critical value ($7.03 > 5.991$) at 0.05 level of significance, one should reject the null hypohesis and accept the research hypothesis. The conclusion is that there is a relationship between savings account and motives and that the religious element is dominant. Figures in the table show that customers are more likely to have saving accounts for religious reasons.

However, the null hypothesis is to be accepted and the research hypothesis rejected at 0.01 significance level, ($\chi^2 = 7.03 < 9.21$). This does not, however, negate the dominance of the religious factor.

(III). Investment accounts:

It is more important to test the degree of motives with regard to investment accounts. Investment accounts are vital for IBs as a component of total deposits. Again, the frequency distribution analysis and chi-square tests show that depositors deal with IBs basically on religious grounds. If, however, this is true in the case of current and saving accounts, is it the same for investment accounts?

The argument is that IBs are competitive in attracting investment deposits since they are capable of realising profits and distributing high returns on investment deposits. In other words, the argument should be that IBs depend not only on the religious factor to attract customers to open investment accounts, but also on their competitive rates of return. Hence the set of motives expected to affect depositors' decision on investment account are taken to be: (1) the religious element and (2) competitive rates of return.

Put in statistical form, the above argument can be formulated as follows:

- The null hypothesis should state that the variables are unrelated or independent of one another, so that the investment account holding is not affected by motives. In other words, motives have the same impact on investment account holding, (χ^2 is not larger than would be expected by chance).

- The alternative hypothesis should state that the variables are related or dependent (i.e. motives do affect investment account holding) and that the religious element is more significant than the competitive rate of return, (χ^2 is larger than would be expected by chance). Table C below shows the results for the investment account tests using the SPSSX programme.

Crosstabulation (C): motive by investment account preference

	Motives	
	religious	competitive return
Investment account	20 (13.5)*	7 (13.5)

* Expected frequencies; $\chi^2 = 6.2$; $df = 1$

Following the same procedure of testing hypothesis, the calculated value of χ^2 is higher than the tabulated value ($\chi^2 = 6.2 > 3.481$) at 0.05 significance level, implying a rejection of the null hypothesis and acceptance of the research hypothesis. Thus there is an association between these motives and investment account, which indicates that their impact is not the same. The effect of the religious motive was greater than that of the rate of return. Looking at the figures in the table, it is obvious that customers are more likely to hold investment accounts for religious reasons.

- Summary:

IBs were able to attract new clients and to convince others who already had banking relation with conventional banks to deal with them.

IBs have a fairly good share in the deposit market. The point is how to maintain this share. The logical step is for them to build on their relationship with their customers. This should be done by satisfying customer needs and requirements. These motives were listed as : (1) religious, ie. interest-free transactions, (2) competitive (high) rates of return on investment deposits, (3) greater access to banking credit facilities, (4) competitive (good) services and (5) a wide spread of services (high bank intensity).

However, the descriptive statistics (frequency distribution) analysis and other statistical tests prove that the religious element is ranked first in importance for customers. Fortunately for IBs, the competitive service and wide spread of services rank after the religious element. Thus customers deal with IBs basically for these three reasons. One finding which is unfavourable for IBs is that customers were not attracted by high returns or by greater access to credit facilities. Thus apart from the competitive service and widespread objectives, the religious element was found to be dominant even in the distribution of deposits among different accounts.

The conclusion is that IBs should work to maintain their bank-customer relationship, and hence their market share, by giving more funds to customers – which is important since the majority of depositors are from low-income groups (vide supra) – and by distributing high profit rates. This is crucial since IBs can not, and should not, depend on the religious motive alone. Since they are now

relatively competitive in extending services, and since their intensity is fairly high, they can also be competitive in the returns they distribute and in giving more credit facilities to their customers. In this way, they can enhance their relationship with their customers and thus uphold their market share.

It has been stated above that the investment account is an important component of total deposits. It is important in the sense that depositors put their savings in this type of account for the purpose of investment and the bank can use deposits in income-generating activities. The greater the share of investment deposits in total deposits, the longer the maturity of deposits. If deposits are predominantly of a long-term nature, the bank will be in a better position to undertake more productive (long-term) investments, and it will not encounter illiquidity difficulties.

Therefore if IBs are to improve their position, they should encourage their customers to have investment accounts. What is the attitude of IB customers towards investment accounts? Do they hold these investment accounts without being willing to share the risk involved? In other words, do they open these accounts for religious satisfaction only, disregarding the economic element? Below is a discussion of this point and its implications for the bank-customer relationship.

7.5.3 Customer attitudes towards investment accounts

It was mentioned earlier that the investment account is a vital component of deposits with IBs. If IBs are efficient in carrying out their operations, they can convince depositors and attract a large number of depositors for investment accounts. If they can secure a relatively large proportion of depositors in investment accounts, they will be able to maintain their market share and be in a better position to carry out long-term investments.

The assumption is now that depositors of IBs are ready to take risks, but at the same time expect a reasonably high rate of return on their deposits. Their willingness to take risks might be attributed to a great extent to their religious motive, but the argument remains valid that these depositors are risk-takers in the purely economic sense of the word. Although depositors still did not receive high return on deposits, they had the will to accept uncertain return on investment accounts. This is a point which will be tested later in this section.

The purpose here, however, is to see how the bank-customer relationship is affected by the clients' attitude towards investment accounts. Customers' behaviour can be approached more closely by discussing their responses regarding investment accounts (vs. time deposit account) as a risky account in the sense of being uncertain with regard to the guarantee of the value of deposit or of the return. Thus the tendency of risk-taking by IBs customers could be indicated through two steps: firstly, sacrificing guarantee by banks of the value of investment deposits (as do traditional banks) and, secondly by sacrificing the guarantee of a fixed rate of return (rate of interest).

7.5.3.1 Risk-taking : via accepting loss of deposit value

(a) Frequency distribution analysis:

To elaborate this point, depositors were asked to answer certain questions as follows:

Firstly, 'Does non-withdrawal condition affect your decision to open an investment account?'

Customers' responses showed that they can have investment accounts and sacrifice 'waiting'. This finding was supported by their replies that they accepted the non-withdrawal condition stipulated by IBs for those holding investment accounts.²⁹ Out of 198 depositors addressed, 116 (58.6%) replied that non-withdrawal condition did not affect their decision to open an investment account, while 82 (41.4%) responded that this condition did affect their decision.

Secondly, customer willingness to take risks was revealed more clearly by their responses to the question: 'Does the probable loss on investment accounts affect your decision to open an investment account ?'

As can be seen, from responses that were given (Table 7.9), the majority said that loss does not affect them, a result which provides evidence for their risk-taking tendency.

²⁹ The minimum period specified for non-withdrawal is three months.

Thirdly, depositors were asked to state whether they 'prefer investment (*PLS*) or time deposit (TD) account'. Replies to this question are displayed in Table 7.10. below:

Table 7.9: Loss Effect on Preference of Investment Account

Responses	Frequency	Valid percent
Yes (loss affects)	37	18.7
No (does not affect)	161	81.3
Total	198	100

Source: Depositors' Survey, 1989.

Table 7.10 Choice Between *PLS* & TD

Replies	Frequency	Valid percent
<i>PLS</i>	166	83.8
TD	32	16.2
Total	198	100.0

Source: Depositors' Survey, 1989.

As it appears, the majority of clients prefer the investment account, 83.8%, (whether, however, this is for religious reasons will be tested later). Only 16.2% prefer a time deposit account according to their experience with IBs and that with conventional banks and according to their knowledge on both types of account.

Fourthly, in order to test how prepared depositors were to endure loss and take risk, they were asked again to indicate the relative importance of guaranteeing the value of deposit. Responses given by depositors to the question: 'Is the guarantee of deposit value important?' are shown below (Table 7.11).

It seems that a reasonably large number of depositors (38.4%) would be prepared to take the risk of losing part or all of the deposit value.

All the above findings support the opinion that IBs customers are not 'risk-avoiders' and are willing to take risks with a bank, i.e. accepting loss of part or

all of the value of deposits. This could allow IBs to uphold their market share persistently, and to mobilise resources which could be of a long-term nature and which would be placed in medium and long-term investments without the IBs facing any illiquidity situation.

Table 7.11 Importance of Guaranteeing Deposit Value

Relative importance	Frequency	Valid percent
Not important	76	38.4
Important	72	36.4
greatly important	50	25.2

Source: Depositors' Survey, 1989.

However, do other statistical tests support the argument that IBs depositors are 'risk-takers'? This question can be answered by crosstabulating the frequency distribution of responses for different questions with each other.

(b) Crosstabulation analysis:

- Firstly, it has been shown above that IB depositors are willing to take risks. This was clear from: (i) their responses to the effect that loss does not affect their decision to open investment accounts and (ii) the fact that they prefer investment accounts to time deposits. To test this finding, responses regarding the effect of loss (only 'yes' responses were taken, see above) were crosstabulated by responses on the preference for investment (*PLS*) and time deposit (*TD*) accounts. The following results were found:

Crosstabulation (D): Loss effect by account preference

Loss effect	<i>PLS</i>	<i>TD</i>	Total
Yes loss affects account preferenc	10 (18.5)*	27 (18.5)	37 -

* Expected frequencies; $\chi^2 = 7.8$; $df = 1$

The argument is that depositors prefer *PLS* account more than TD account and that the probability of loss does not affect their decision on investment account.

Put in statistical form:

- The null hypothesis is that there is no association between the expectation of loss and account preference (the variables are independent). In this case the expectation of loss has no influence on the customers when choosing between *PLS* and TD accounts.

-The alternative hypothesis should state that loss expectation does affect customers' decision to open a *PLS* account or TD account. In this particular case it should be stated that the effect of the probable loss is less on the *PLS* account than on the TD account, and that IBs depositors are willing to take risks of loss (irrespective of the cause, the especially religious cause).

Comparing the calculated value of χ^2 to the tabulated vlaues:

$$\chi^2 = 7.8 > 3.841 \text{ at } 0.05 \text{ significance level}$$

$$\chi^2 = 7.8 > 6.635 \text{ at } 0.01 \text{ significance level}$$

Since the calculated value (χ^2) is higher than the critical value, the decision here is to reject the null hypothesis and accept the research hypothesis. The conclusion is that the probability of loss does affect customer preference, but its effect on investment account holders is less (since they accept the risk of loss). If one looks at the figures in the table above, one can see that those who prefer investment accounts are less likely to say that loss affects their decision to hold *PLS* account, while those who prefer TD account are more likely to say that it does.

- Secondly, as mentioned earlier in this section, when depositors were asked to indicate the relative importance of the guarantee of deposit value, those who prefer the *PLS* account gave less relative importance to the guarantee of deposit value. The argument is that the clients who prefer the (risky) *PLS* account are more willing to accept loss of part or all of the deposit value; therefore they gave less importance to the guaranteeing of deposit value as compared with those who preferred the TD account.

More evidence for this argument can be supplied by crosstabulating account preference by the relative importance of guarantee of deposit value. The SPSSX programme produced the following result:

Crosstabulation (E): Preferred account by guarantee of deposit value

Preferred account	Relative importance			Total
	not important	important	greatly impotent	
<i>PLS</i>	75 (45.2)*	61 (36.7)	30 (18.1)	166 -
TD	1 (3.1)	11 (34.4)	20 (62.5)	22 -
Total	76	72	50	198

* Expected frquencies; $\chi^2 = 33.37$; $df = 2$

Put in statistical form, the following assumption can be stated:

- The null hypothesis should state that there is no relation between preferred accounts and the relative importance of guarantee of deposit value. That is to say, the variables are unrelated or are independent of one another.

- The alternative hypothesis should state that there is an association between the variables and that the relative importance of guarantee of deposit value for *PLS* and TD accounts is different. In other words, those who preferred the *PLS* account gave less relative importance to the guarantee of deposit value.

Since the calculated value is higher than the critical value at all levels:

$$\chi^2 = 33.37 > 3.841 \text{ at } 0.05 \text{ probability level}$$

$$\chi^2 = 33.37 > 6.635 \text{ at } 0.01 \text{ probability level,}$$

The decision to be made is to reject the null hypothesis and accept the research hypothesis. The conclusion is that customers who prefer the *PLS* account are genuine and serious in giving less relative importance to the loss of part or all of the deposit value of the *PLS* account. If one looks at the figures in the cells of

the table, one can see that those who preferred the *PLS* account and who gave no importance to guarantee of deposit value outnumber those who preferred TD account.

- Thirdly, is this risk-taking (accepting loss of deposit value) for religious reasons?

The above chi-square tests prove that depositors are risk-takers and are willing to hold *PLS* accounts despite probable loss. Might this willingness to take risk be attributed to religious motives rather than economic factors?

To test the validity of this point, responses of IB depositors who cited religious reasons (vide supra, Table 7.7) and high returns (as an economic factor) were crosstabulated by the responses for the relative importance of guaranteeing deposits. Now the assumptions are as follows:

- The null hypothesis is that both the religious reason and the rate of return (as an economic, not religious, element) are unrelated to the willingness of depositors to take risks (of accepting loss of part or all of the value of deposit), i.e. the variables are independent, with both religious reason and the rate of return having the same impact on customers' willingness to take risk.

- The research hypothesis should state that there is a relationship between these two factors and the depositors' willingness to take risk, and that the religious element is stronger, i.e. customers accept loss on a religious rather than economic basis (economic factor is less important for depositors to accept risk).

Using the *minitab* programme to calculate χ^2 , the results obtained are shown on the Table Crosstabulation (F).

Comparing the calculated value to the critical value:

$$\chi^2 = 1.85 < 5.991 \text{ at } 0.05 \text{ probability level}$$

$$\chi^2 = 1.85 < 9.21 \text{ at } 0.01 \text{ probability level}$$

Therefore the decision is that the alternative hypothesis is to be rejected, and the null hypothesis accepted (χ^2 is lower than the tabulated value at all levels). The conclusion is that the religious element had no greater impact on willingness

to take risks than did the economic factor. This finding indicates that customers are willing to take risks even on economic basis.

Crosstabulation (F): motive by guarantee of deposit value

Motive	Relative importance			Total
	not important	important	greatly important	
Religious	67 (66.8)*	55 (56.9)	27 (25.3)	149
High return	7 (7.2)	8 (6.1)	1 (2.7)	16
Total	74	63	28	165

★ Expected frequencies; $\chi^2 = 1.85$; $df = 2$

The frequency distribution findings and chi-square tests have both indicated that IB depositors are willing to take the risks associated with *PLS* account not only for religious reasons but also on an economic basis. In other words, IBs could find depositors who are ready to have investment accounts, sacrificing the ‘waiting’ and willing to accept loss when incurred. Thus, IBs are able to maintain their market share providing they carry out their operations efficiently, attracting more depositors through good service and the spreading of branches, and giving more credit facilities. In short, IBs can enhance their relationship with their customers since depositors have shown a desire to take risks.

In fact, depositors of IBs are not only willing to risk losing their deposit value, they are ready to accept uncertainty on return. This point is discussed in detail below.

7.5.3.2 Risk-taking: via accepting variable rerturn

The survey finding revealed that customers prefer the *PLS* account to the TD account. Frequency distribution disclosed that 166 depositors (83.8%) preferred *PLS* account while 32 (16.2%) preferred TD account (see the above section).

The point now is to discover whether this finding is strong enough to indicate that those who prefer the *PLS* account are genuine in accepting the probability

of not having a guaranteed rate of return. It was shown above that IB depositors are willing to accept loss of part or all of the value of deposits. In this respect, do they maintain the same willingness to accept a variable rate of return? This question can be answered by crosstabulating depositors' preference for the *PLS* account (which implies variable rate of return) and the TD account by depositors' attitudes to the relative importance of guaranteeing rate of return. The argument is that guaranteeing the rate of return on the part of the bank is important for both groups of customers, i.e. for those who prefer *PLS* account and those who prefer TD account. The assumption to be tested in statistical form is as follows:

- The null hypothesis is that there is no relation between the type of account preferred by customers on the one hand, and the relative importance of guaranteeing return as indicated by customers on the other hand; it should be understood that the *PLS* account involves uncertain returns while the TD account guarantees a fixed return. The null hypothesis implies that a guarantee of certain rate of return is as important for those who prefer the *PLS* account as it is for those who prefer the TD account.

- The alternative hypothesis should state that there is an association between the two variables (preference of account and guarantee of certain return) and that a guarantee of fixed return is *less important* for those who preferred the *PLS* account than it is for those who preferred the TD account.

Running the SPSSX programme, the results obtained are shown on below:

Crosstabulation (G): account preference by guaranteeing return

Preferred account	Relative importance			Total
	not important	important	greatly important	
<i>PLS</i>	47 (28.3)*	83 (50.0)	36 (21.7)	166 -
TD	1 (3.1)	21 (65.6)	10 (31.3)	32 -
Total	48	104	46	198

* Expected frequency; $\chi^2 = 9.32434$; $df = 2$

Comparing the calculated value to the tabulated values:

$$\chi^2 = 9.32434 > 5.191 \text{ at } 0.05 \text{ significance level}$$

$$\chi^2 = 9.32434 > 6.635 \text{ at } 0.01 \text{ significance level}$$

Since, however, the calculated value is higher than the critical value(s), the decision to be made is to reject the null hypothesis and accept the research hypothesis. The conclusion is that customers who prefer the *PLS* account are willing to accept variable (uncertain) rates of return. If one looks at the figures in the cells of the table (expected frequencies), one can see that those who preferred the *PLS* account and who attached no importance to a guaranteed rate of return outnumber those who preferred the TD account.

- Secondly, does this risk-taking (accepting uncertain rate of return) have a religious motive?

Again, as in the case of accepting loss on deposit value, it might be argued that depositors accept variable (uncertain) returns on religious grounds alone. However, in order to show that depositors accept uncertain returns not only for religious cause but also on an economic basis, the motives for dealing with IBs (religious element and return motive) were crosstabulated by the relative importance of guaranteeing the rate of return. The following contingency table reveals the results (using *minitab* programme):

Crosstabulation (H): motive by guarantee of return

Motive	Relative importance			Total
	not important	important	greatly important	
Religious	41 (42.4)*	77 (75.9)	31 (30.7)	149 -
High return	6 (4.6)	7 (8.1)	3 (3.3)	16 -
Total	47	84	34	165

* Expected frequencies; $\chi^2 = 9.32434$; $df = 2$

The argument, in statistical form, is as follows:

- The null hypothesis should state that there is no relationship between the motives on the one hand and the importance of guaranteeing return on the other, i.e. the variables are independent and both the religious element and the rate of return motive have the same effect on the opinion of depositors when indicating the relative importance of guaranteeing return.

- The research hypothesis should state that the variables are dependent and that the impact of religious element is stronger than that of the rate of return.

Comparing the calculated value to the critical value(s):

$$\chi^2 = 0.71 < 5.991 \text{ at } 0.05 \text{ level of significance}$$

$$\chi^2 = 0.71 < 9.21 \text{ at } 0.01 \text{ level of significance}$$

Since the calculated value is lower than the critical value(s), the decision to be made is to reject the alternative hypothesis and accept the null hypothesis. The conclusion therefore, is that customers accept uncertain rates of return not only for religious reason, but also on economic grounds.

- Summary:

One may conclude here by stating that IB depositors are risk-takers. They risk loss of deposit value and accept uncertain rates of return. This attitude is based on both religious and economic reasons.

This finding is quite important since IBs should understand the behaviour of depositors so that they can forge a strong relationship with their customers. It should be clear that although customers are willing to accept the non-withdrawal condition imposed on investment accounts, and uncertainty on both deposit value and returns, they do expect a high return on their deposits. The fact is that despite not getting enough returns on their deposits, they continue hold these deposits, a fact which the IBs should take into consideration. This is vital since it affects directly the bank-customer relationship, a relationship which should be built on an economic rather than a religious basis.

One of the factors affecting the banks' market share is the level at which they carry out their services. If IBs are capable of serving clients efficiently, they will attract more customers and hence influence positively their market share.

7.5.4 Bank-customer relationship: via competitive services

To study every aspect of the relationship between IBs and their customers, it is appropriate to see the degree of competitiveness of IBs' services as one of the determinants affecting this relationship.

If IBs, as competing financial institutions, are to maintain their market share, they must conduct and develop a strong and lasting relationship with their customers. The question now posed is, 'How efficient are IBs in extending normal bank services?'

7.5.4.1 Competitiveness

(a) Frequency distribution analysis:

In order to gauge degree of competitiveness of services, depositors were asked: 'What is the level of IBs services?' Responses to this question are shown in Table 7.12. It is clear that IBs carry out their services to a relatively satisfactory level. These responses can be said to have revealed the true situation to a great extent for two reasons:

Table 7.12: Competitiveness of Services

Level of service	frequency	Valid percent
Bad	5	2.5
Fair	41	20.7
Good	97	49.0
Very good	55	27.8
Total	198	100.0

Source: Depositors Survey, 1989.

(1) Depositors had already indicated that the second most important reason for their dealing with IBs was that the services are good, (vide supra).

(2) Most of the depositors addressed by the questionnaire are found to be literate: 112 depositors (i.e. 56.5%) filled in the questionnaire by themselves.

(b) Crosstabulation analysis:

Depositors first indicated that the competitive service motive is second in importance as a reason for their dealings with IBs (see Table A), now they have shown that the level of services is good. Are depositors consistent in ranking competitive services as the second most important motive in their dealings with IBs while at the same time indicating elsewhere that the level of services is very good? This point will be tested below.

However, not only frequency distribution, but even the crosstabulation confirms the above findings and shows that depositors have been consistent in assessing the level of services.

When affirmative responses on the competitiveness of services (as a motive to deal with IBs which was ranked second) were crosstabulated by responses on the question 'What is the level of IBs services?', the following results were obtained:

Crosstabulation (I): motive of competitiveness by Level of Services

Motive	Level of service				Total
	Bad	Fair	Good	Very good	Totl
Competitive service	1 (24.5)*	9 (24.5)	48 (24.5)	40 (24.5)	98 -

* Expected frequencies; $\chi^2 = 62.9$; $df = 3$

Assumptions are:

- The null hypothesis should state that there is no relationship between depositors' responses on competitiveness of the services motive and their responses on the level of bank service, i.e. both variables are independent and customers are inconsistent in their estimation of the bank service.

- The alternative hypothesis should state that depositors are consistent in their estimation and that IBs are truly competitive.

Comparing the calculated value ($\chi^2 = 62.9$) with tabulated values, it is quite obvious that the former is higher than the latter at all levels of significance. Therefore the decision is to reject the null hypothesis and accept the research hypothesis. The conclusion is that depositors are *consistent* in their opinion and that IBs are carrying out their services fairly adequately.

If IBs are carrying out their services adequately, do their customers use all these services, and, if not, why not?

7.5.4.2 Types of services used

(a) Frequency distribution analysis:

- First, depositors were asked to indicate the type of services they used with the question: 'Which of the following banking services do you use: (1) different account services, (2) letters of credit and guarantee services, (3) money transfer and buying (selling) of currency; (4) credit facilities (loans). The following responses were revealed:

Table 7.13: Depositors: Types of Service Used

Type of service	Frequency	Valid percent*
Different account services	159	50.5
letters of credit and guarantee	70	22.2
Money transfer	30	9.5
Credit facilities	56	17.8
Total	315	100

* Valid percentages were taken here not from 198, which is the number of depositors, but from 315 since some depositors are using more than one type of service.

Source: Depositors Survey, 1989.

It is obvious that most depositors use account services only. This may, however, result either from the fact that customers are not granted credit facilities unless they have opened an account with the bank, or that they do not know about the other services. It is also clear that a fairly large number of depositors use letters of

credit and guarantee services because there is a great demand for letters of credit, particularly to finance foreign trade, and also a high demand to issue letters of guarantee.

The above data confirms the earlier assertion that still few customers come to IBs to get credit facilities. Here only 56 depositors indicated that they use credit facilities. However, because of the importance of this as a service attracting more clients, depositors were asked to state 'whether they know all policies of IBs on credit facilities?' 79 (39.9%) replied that they know about all bank policies on credit facilities, while 119 (60.1%) replied that they did not know about these policies. This result confirms the finding that IBs still do not extend credit facilities to a large number of customers.

It seems that not only the majority of depositors are ignorant of conditions and policies on credit facilities and that few of them use these facilities, but even the few who use these facilities are not from the low-income depositors, the group which is in desperate need of help. It is therefore appropriate to identify the classes of depositors who use credit facilities.

It was mentioned earlier that IBs attracted new (low-income) depositors to the banking circles. However, do they allow them more access to credit facilities? Table 7.14 below shows the distribution of depositors who used to get credit facilities and who indicated that they use credit facility services:

Table 7.14: Depositors' classes: access to and use of credit facilities

Income class (LS 000)	1-10	11-20	above 20	Total
I have access to credit facilities	10 20.4%	8 16.3%	31 63.3%	49 -
I use credit facility	10 17.9%	12 21.4%	34 60.7%	56 -

Source: Depositors Survey, 1989.

It is clear that the majority of depositors whose motive is to get credit facilities are from the high-income group. Moreover, those who actually used to obtain

credit facilities are also those from high-income group. Therefore one would say that although IBs attracted new depositors from low-income groups, they did not grant them more credit facilities.

- Secondly, what attracts attention here is the fact that although customers are ignorant of the IBs' policies on credit facilities, they are generally aware of other services.

Depositors were asked again to indicate 'why they do not use all bank services?'

The reasons for this, as given by depositors, appear in Table 7.15.

Thus although a large number (81) of depositors use only one service because they are unaware of others, those who know about but do not use them, or can not fulfil the conditions, are in the majority. This situation might be attributable to the relative wide spread of IBs as mentioned earlier (this point will be tested below).

Table 7.15: Reasons for Not Using All Services

Reason	Frequency	Valid percent
I do not know other services	81	41
I do not need others	86	43.4
I can not fulfil conditions of services	31	15.6
Total	198	100

Source: Depositors Survey, 1989.

(b) Crosstabulation analysis:

- As stated above, customers use basically different accounts services and letters of credit and guarantee services, while fewer clients use credit facilities services. Crosstabulation confirms this finding. The statement 'I deal with IBs to get credit facilities' was crosstabulated by the responses to the question 'Do you use credit facility services?' The crosstabulation results are shown in the table below:

Crosstabulation (K): Motive by Use of Credit Facility

Motive	Customers who use credit facility		Total
	Yes	No	
More access to credit facilities	22 (24.5)*	27 (24.5)	49 -

* Expected frequencies; $\chi^2 = 0.5$; $df = 1$

The assumption to be tested is as follows:

- The null hypothesis should state that the motive to have more access to credit facility has still no effect on the extent to which IBs' depositors use credit facility services.

- The alternative hypothesis is that greater access to get credit has an impact on the use of credit facility services. In other words, IBs allowed customers greater access to credits.

Comparing the calculated value to the critical value(s):

$\chi^2 = 0.5 < 3.84$ at 0.05 significance level.

$\chi^2 = 0.5 < 6.635$ at 0.01 significance level.

Therefore, the decision is to reject the alternative hypothesis and accept the null hypothesis. That is to say, a limited number of customers were allowed to have access to credit facilities. IBs thus need to work harder to give more credit to customers.

- As shown above, a large number of depositors did not use all of banks' services, not because they did not know about them, but because they might not need them or could not fulfil the conditions. To test this point, responses to the statement 'I deal with IBs for their wide spread of services' (which affects positively clients' knowledge) were crosstabulated by responses to the question 'Why you do not use all bank services?' Crosstabulation gives the results shown in the following table :

Crosstabulation (L): motive by reason for use of one Service

Motive	Reasons			Total
	Ido not know other	Ido not need other	Ican not fulfil conditions	
Widespread of service	18 (18.6)*	34 (18.6)	4 (18.6)	56 -

* Expected frequencies; $\chi^2 = 24.4$; $df = 3$

Assumptions:

- The null hypothesis is that the wide spread did not affect the knowledge of customers, since a large number of them do not know about these services (a situation that may result from the limited spread of bank services).

-The research hypothesis is that the wide spread did affect customers' knowledge, so that if there is a relatively large number of customers who do not use all bank services, it is not because of their ignorance of these services, but either they do not need these services or they do not fulfil conditions.

Compared to the tabulated value(s):

$$\chi^2 = 24.14 > 7.815 \text{ at } 0.05 \text{ significance level}$$

$$\chi^2 = 24.14 > 11.34 \text{ at } 0.01 \text{ significance level}$$

Thus the calculated value is higher than the critical value at all levels. The decision is to reject the null hypothesis and accept the research hypothesis. In other words, IBs did affect customers' knowledge through the wide spread of services, a finding which is in favour of IBs playing a role in monetising the economy.

● **Conclusion:**

IBs have to maintain their market share. One of the factors that affects maintenance of market share is the attitude of depositors and their relationship with banks. Thus, the bank-customer relationship is a major determinant in upholding the market share.

The most crucial element in the relationship between IBs and their customers is the religious factor. This affects not only their decision to deal with IBs but also their choice of accounts. The survey finding has pointed out clearly that the religious factor is more effective in determining the bank-customer relationship and therefore affects the support of the market share. Customers still deal with IBs on religious basis.

The survey findings also indicate that IBs are competitive in extending bank services, and that their services are relatively widely-spread compared with other banks.

One finding which is unfavourable to IBs is that the rate of return on investment deposits is still not high enough to attract more depositors. Moreover, the depositors' responses reveal that IBs have not extended credits to a large number of depositors, because the 'access to use bank credit facility' is among the least important motives for depositors to deal with IBs.

If, however, the relationship between banks and customers is still based on religious factor, and if IBs still do not attract clients by giving high returns on investment deposits or by giving more credit facilities, this will discourage customers from dealing with these banks and thus affect their market share.

IBs' depositors are risk-takers since they deal with *PLS* accounts. Responses given by depositors reveal that they are ready to accept a loss on the value of deposit as well as an uncertain rate of return. This is for both religious and economic reasons. IBs can enhance this risk-taking behaviour in order to maintain their market share, absorbing more savings on a long-term basis which they could then direct into long-term investments.

However, to this point, this is the first chief determinant of market share of IBs, via the attitude of customers. The second chief determinant is the attitude of IBs managers towards raising and encouraging savings, in other words, attracting more deposits and continuing to uphold the amount of savings absorbed.

7.6 Management Attitude

Management behaviour towards customers and their efforts to raise savings is

regarded as one determinant of the market share of IBs. However, to grasp the role of management in this respect, managers of IBs, like depositors, were given a different set of questions. The following procedure was adopted:

7.6.1 Managers Questionnaire

7.6.1.1 Structure and interview

A questionnaire was formulated to address managers of IBs. It was composed of four parts: the first part concerning the role of IBs in savings mobilisation; the second part concerning investment and savings allocation; the third part concerning IBs relation with the Central Bank and financial authorities; and the fourth concerning these banks' policies vis-a-vis the distribution of profits.

In order to allow the managers to express themselves at some length, but without the risk of them giving lengthy aimless talks, the author also opted for a semi-structured type of interview, (see E. C. Wragg (1978), M. H. Agar (1980)).

7.6.1.2 Administration of the questionnaire and interview

It is worth mentioning here that in the case of the managers there was no sampling or pre-testing done. All six managers (total population) were addressed. The questionnaire forms were distributed and remained with managers for two weeks. They answered the closed questions and waited for interviews for the other questions. Therefore, the interviewees (managers) and the author were often involved in discussion.

The main difficulties encountered in administering the questionnaire was that the managers were always busy. On several occasions interviews with them were postponed. However, there is no doubt that they have been co-operative in answering the questions.

7.6.2 Questionnaire: discussion

What is the attitude of managers towards raising deposits and maintaining the market share?

From the questionnaire responses reveal that:

For all IBs, except the Co-operative Development Bank, efforts to raise saving knowledge depend on advertisements in newspapers and a single television channel, and on direct contact and brochures. However, the method of raising savers' knowledge through the mass media is not very fruitful since the majority of people are illiterate, which means that few of them can read newspapers or watch TV; secondly, people's access to newspapers and TVs is limited because these media are available almost exclusively in urban areas.

On the other hand, the Islāmic Co-operative Development Bank invented a better method of raising funds, namely the '*Fund of Productive Families*'. The idea behind it is that the bank accepts a small amount of funds, which are put in a special account, and the collected sum is used to buy productive equipment such as sewing machines, egg-producer machines etc. This method is attractive and has produced good results for the bank.

From the responses of managers it appears that no one Islāmic bank gives incentives to small depositors in the form of gratis loans or concessionary facilities to buy such things with nominal profits.

No Islāmic bank offers different investment accounts characterised by different risks. If this were provided, it would help encourage people to put their money in an investment account and have the same say in how these savings are allocated; at present, depositors of IBs have no influence on management decision, even though they are exposed to risk.

The answers given by the managers reveal that no specified deposits were offered; all deposits are general, a practice which might affect the decision of depositors to open investment accounts. It is also obvious that both depositor's funds and shareholders' funds are allocated in the same project, without differentiating between the motives of depositors who prefer less risky, short-term projects, and the motives of shareholders who look for more riskier and long-term projects. One explanation for this might be that it is difficult to manage these deposits separately and develop an accounting procedure which would enable the proper share of deposits in profits to be calculated. However, the policy of distributing profits is one of the factors which affects the market share (see below).

Thus it seems that the effort of managers (management attitude) to raise and maintain deposits is still not very effective. This limits the share of IBs in the deposit market. It is true, however, that the religious motive is a prime mover for the majority of depositors, but it has been seen earlier (*vide supra*) that depositors are risk-takers, not only for religious purpose, but on an economic basis. Thus management attitude should enhance the depositors' behaviour and make for more productive methods of raising savings. Dependence on religiously-motivated customers is serious and is much more likely to jeopardise IBs market share.

The third fundamental determinant of market share is the attitude of the authorities towards commercial banks in general and IBs in particular. This determinant has its tangible impact on the form and allocation of deposits and, consequently, on the market share. The authorities' attitude will be dealt with in the discussion on credit policies.

7.7 The Attitude of the Authorities

By authorities here is meant the monetary authorities in particular; their attitude implies the nature of the policies they adopt and implement. What is the nature of these policies, and what are their implications?

7.7.1 Credit policies

The tracing of credit policies adopted by the Central Bank shows that they have been gradually restricting the liquidity of commercial banks. The evidence for this will appear in the following review of these policies.

In 1964, the Central Bank transferred the time deposit of the Sudan Gazera Board from the commercial banks, an action aimed at reducing the liquidity with the banks.

During the 1970s and 1980s, credit policies became more stringent. In August 1983, for instance, the Bank of Sudan issued a declaration to limit banks' liquidity by ordering commercial banks to keep cash balances with the Bank of Sudan of not less than 10% of their deposits. Funds of foreign importers with commercial banks were to be transferred to the Bank of Sudan. In 1985, the Bank of Sudan adopted other measures depending on past policies with respect to the limit of

banks' liquidity. In 1986, further credit measures were introduced to enhance the more rigorous former credit policies.

7.7.1.1 Credit policy (1986): description and critique:

In order to explore the nature of credit policies, the credit policy of 1986 is taken as an example.

In general, credit policy covers a number of measures and directives issued by the Central Bank to commercial banks to control money supply and arrange bank lending to the private sector so that it can be used in the productive economic sectors. These measures and directives are concerned firstly with control and rationalisation of banking credit, and secondly with the control of commercial banks' liquidity. Measures which are concerned with the control and rationalisation of banking credit will be discussed in the next chapter. Here is an overview of the measures pertaining to control of banks' liquidity.

(a) Objectives:

To control liquidity of commercial banks, the Central Bank issued the following measures to monitor high liquidity:

Raising the cash reserves of every bank from 12.5% to 20% of the total deposits.

Transferring all funds of the foreign importers from commercial banks to a 'frozen' account at the Central Bank.

Prohibiting inter-lending between banks and keeping investment deposits with each other unless to finance development.

Raising the minimum paid-up capital for foreign banks to 10% of their outstanding lending (or of their deposits) in local currency. Failure to comply would mean they would have to reduce their deposits.

Foreign banks are not allowed to open any kind of account except for customers (importers and exporters) who are registered with the Ministry of Trade, (Bank of Sudan Declarations, November, 1985).

(b) Critique:

Credit policies could play only an insignificant role, in solving some of the financial problems or in affecting the total demand, since the banking sector is insignificant in a developing economy like the Sudan. However, the credit policy might be criticised on the following grounds:

The policy no longer suits an increasing volume of private sector savings (both in foreign and local currency) in the form of deposits that require profitable outlets. In other words, the policy is inappropriate with respect to the increasing need of the Sudanese economy to invest in different economic fields, and with respect to the role of commercial banks in extending development finance.

The policy is aimed at attracting commercial banks to invest in productive sectors. This is a desirable and important step, but neglects the need of commercial banks to generate adequate profits, or at least to reward those who keep deposits and hold shares with commercial banks.

7.7.1.2 Credit policy implications

As a possible determinant, credit policy has implications for the market share of IBs and other banks at two levels: the level of deposit structure and the level of degree of utilisation of these deposits.

(a) Deposit structure:

Implications of credit policies for deposits in general, and their structure in particular, could be identified as follows.

Firstly, although there was a fluctuating annual change for all bank deposits, the degree of fluctuation for IBs was higher, (see Table 7.4 above). This shows the formidable impact of credit policy on deposits.

Secondly – and this is more important – deposit structure has gradually been dominated by the current account, and at the same time saving and time (investment) deposits were shrinking (Table 7.16 and Figure 7.3 (a & b)). Current accounts increased for all banks from 63% in 1983 to 64.6% in 1984 and 73% in 1985. As for IBs, current accounts have been on the increase, from 64% in 1983 to 83% in 1987.

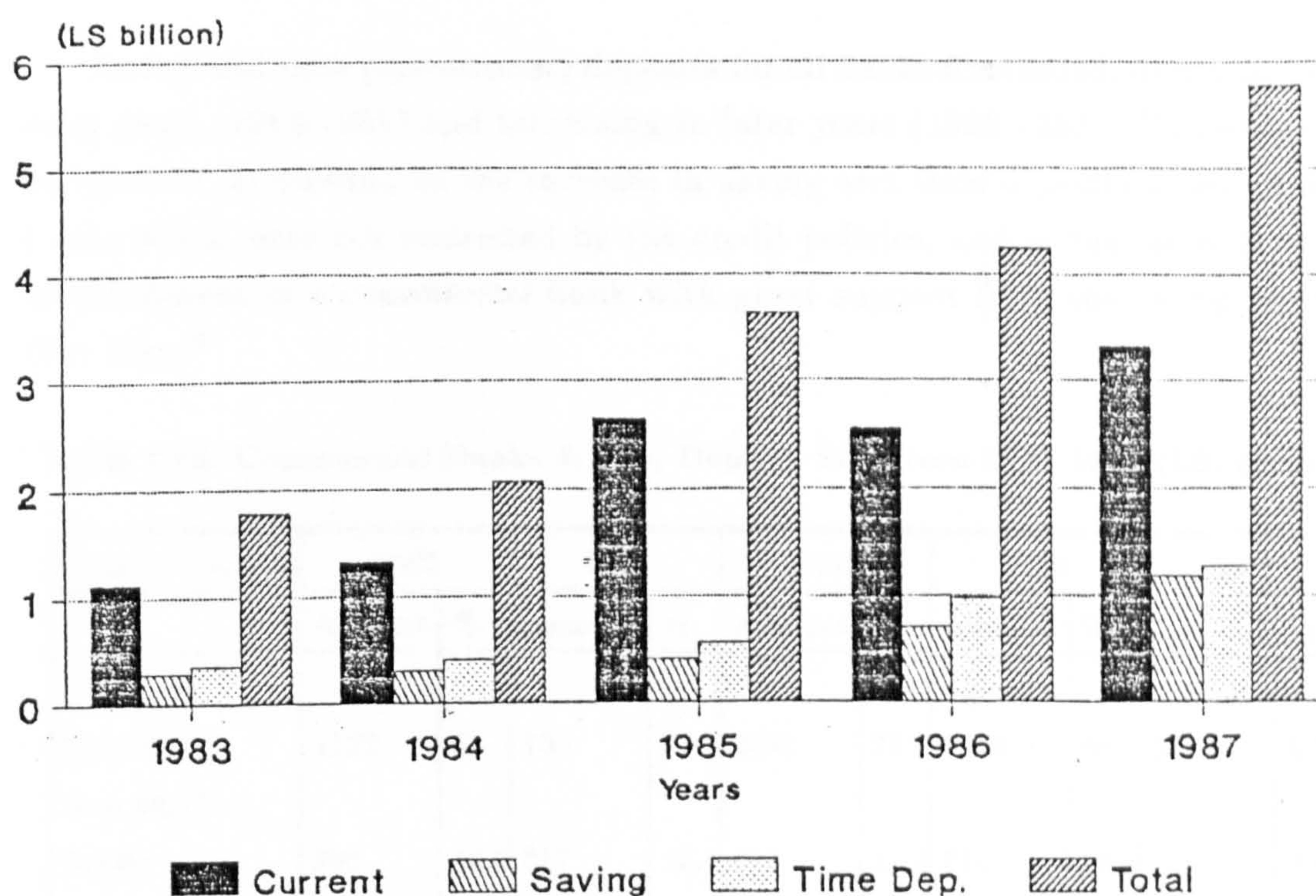


Figure 7.3(a): Banking System Deposit Structure

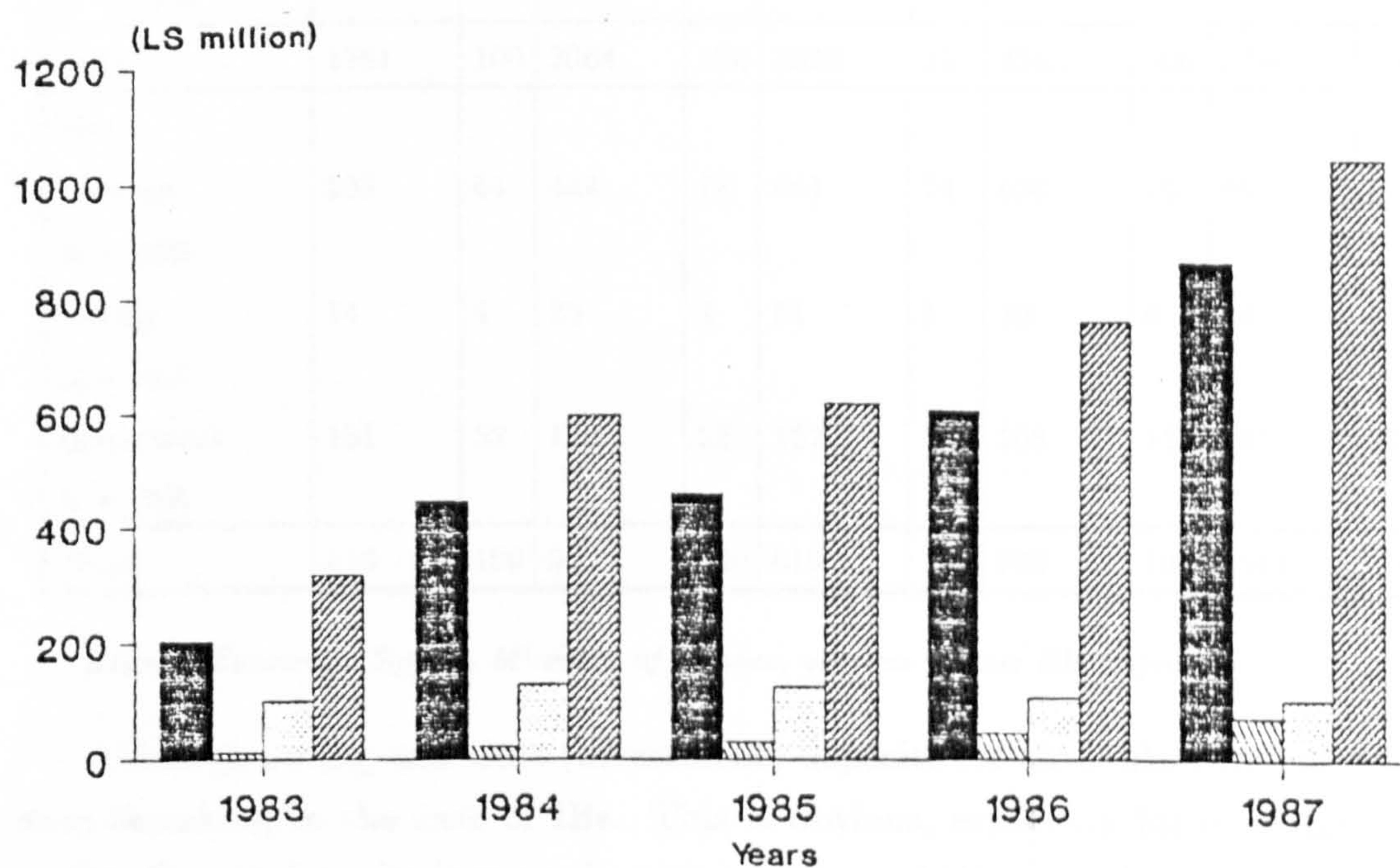


Figure 7.3(b): IBs Deposit Structure

Source: Derived from Table 7.16

Saving and time (investment) deposits for all banks fluctuated, declining in the early years (1983-1985) and increasing in later years (1986-1987). This expansion is, however, attributed to the increase in saving and time deposits of government banks which were not restricted by the credit policies, and is due, as well, to the establishment of a commercial bank with great support from the ruling party at that time.³⁰

Table 7.16: Commercial Banks & IBs, Deposit Structure 1983-1987 (LS. million)

Type of Account	1983		1984		1985		1986		1987	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
All banks:										
Current R = 28.5%	1122	63	133	64.6	2641	73	2549	60	3316	57
Saving R = 36%	290	16.3	317	15.4	414	11.4	714	16.8	1190	20.6
Time deposit R = 35%	369	20.7	413	20	568	15.6	980	23.2	1280	22.4
Total	1781	100	2064	100	3623	100	4243	100	5786	100
IBs:										
Current R = 33%	203	64	444	74	461	74	606	79	867	83
Saving R = -4%	14	4	23	4	31	5	49	6	74	7
Investment R = -3%	101	32	129	22	127	21	108	15	103	10
Total	318	100	59	100	619	100	763	100	1044	100

Source: Economic Syrvey, Ministry of finance, various issues; IBs Reports.

Although saving and time (investment) deposits for all banks expanded, they were shrinking in the case of IBs. This is obvious, especially for investment deposits. Saving deposits increased as a percentage of IBs total deposits from 4% in

³⁰ The *Umma* Party was the government party for the over the period 1986-1989. It established a joint-venture bank with Saudi businessmen called Sudanese-Saudi Bank.

1983 to 7% in 1987. Investment deposits, on the other hand, declined from 32% in 1983 to 21% in 1985 and 10% in 1987, a result which confirms the fact that IBs were affected very much by the credit policies. However, this result is consistent with the fact that IBs have stopped receiving investment deposits since they were unable to invest them.

Thirdly, a better indicator for the expansion of current accounts, as a result of rigorous credit policy and contraction of saving and time (investment) deposits could be the growth rate of these accounts. As revealed in Table 7.16, the component accounts of total deposits for all banks and for IBs showed various degrees of growth over the period in question. Current account grew by 28.5% for all banks and by 33% for IBs. Saving and investment accounts grew by 36% and 35% respectively for all banks and by -4% and -3% for IBs.

Thus, although for all banks, saving and time deposits showed higher growth rates than those of current accounts, this is not a real growth rate because the foreign components of these deposits were revalued as a result of the devaluation of the Sudanese pound from \$ = LS. 2.5 to \$ = LS 12.5 in the mid-1989. For IBs, the growth rates were negative for both saving and investment deposits. This, again, proves that the credit policies affected banks in general and IBs in particular with regard to deposit structure; the progressive expansion of banking deposits in the Sudan has been in current accounts. Saving and time (investment) deposits were crippled by credit policies since they lowered the credit ceilings for all banks, especially IBs.

However, the direct impact of credit policies has not been on deposit structure only, but more tangibly on the degree of utilisation of these deposits.

(b) Degree of deposit utilisation:

Degree of deposit utilisation is measured by the rate of deposit utilisation which is calculated as total investments divided by total deposits.

A more important implication of credit policy has been the decline of the rate of deposit utilisation. Table 7.17 (and Figure 7.4) shows the extent to which all banks and IBs were able to place their mobilised savings into income-generating activities.

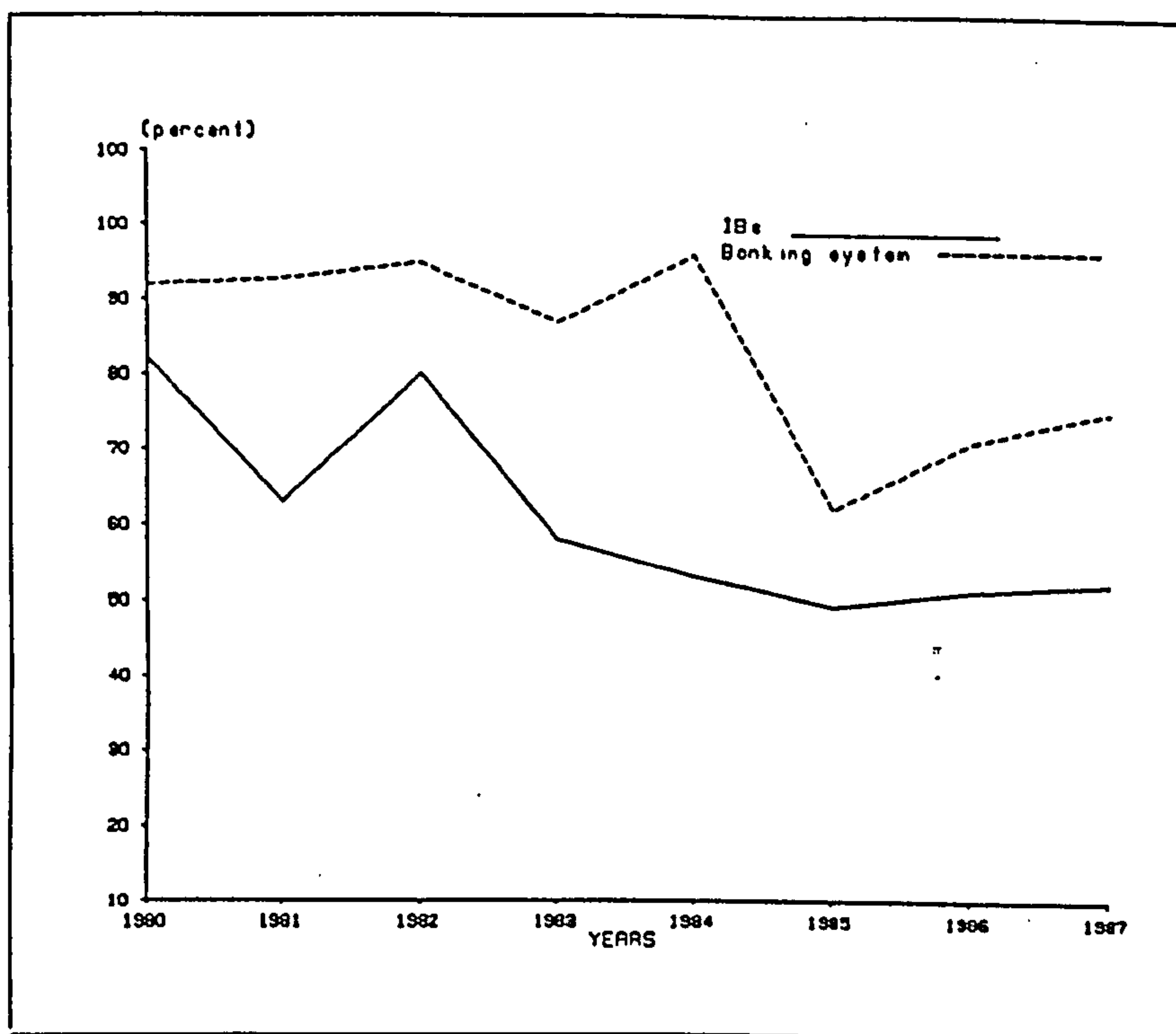


Figure 7.4: IBs & Banking System Deposits Utilisation

Source: Derived from Table 7.17

Table 7.17: IBs: Banking System: Degree of Deposit Utilisation 1980-1987

	All banks			IBs		
	Credits	Deposits	Utilisation	Credits	Deposits	Utilisation
1980	593	720	82	36	50	72
1981	778	943	83	54	102	53
1982	1143	1340	85	143	202	70
1983	1377	1781	77	154	318	48
1984	1777	2064	86	256	596	43
1985	1876	3623	52	239	619	39
1986	2612	4243	61	314	763	41
1987	3793	5786	65	436	1044	42
R	0.29	0.30	-	0.40	0.42	-

Source: Economic Survey, Bank of Sudan, IBs Reports, as amended

Although the growth rates of banks' credit facilities and deposits were nearly the same, 29% for the former and 30% for the latter, the degree of deposit utilisation has decreased over time. Deposit utilisation declined from 82.3% in 1980 to 77.3% in 1983 reaching 52.9% in 1987.

For IBs, growth rates of credits and deposits were similar: 40% for the former and 42% for the latter. However, their degree of deposit utilisation was fluctuating and declining. The rate of deposit utilisation decreased from 72% in 1980 to 48% in 1983, and 42% in 1987.

It is obvious, therefore, that credit facilities affected not only deposit structure, but also the degree to which banks used these resources in financing investments. Of course, the lower degree of deposit utilisation resulted in a low return on deposits, as will be seen later in this chapter.

i. Conclusion

The conclusion is that the attitude of authorities (through public policies and, in particular, credit policies) affected the banking system in general and IBs in particular. Thus, as has been stated above, IB credit policies affected firstly the deposit structure of IBs and secondly the degree of utilisation of these deposits. Both types of impact have direct implications for the market share of IBs. Now, IBs have stopped receiving investment deposits, since they are unable to utilise them. If IBs continue to reject new investment deposits, in the long-run they will have only meagre investment deposits and deposit-structure will be of short-term nature. As a consequence, IBs will not be able to finance long-term projects and this trend will surely jeopardise their existence in the market as financial institutions. Thus, one of the vital determinants of IBs market share is the attitude of authorities as expressed through the credit policies adopted and implemented by the Central Bank. These policies have crippled the size, form and utilisation of deposits.

(B) Market share: Other determinants

There is, as stated before, another set of determinants that are assumed to have affected the deposit share of IBs. These are:

7.8 Are IBs Able to Deal with Interest-based Banks?

In this regard one would first ask what part IBs will be able to play in the inter-bank system and, secondly, how they can hope for any non-Islāmic bank to place funds with them. In other words, how can IBs manage to deal with interest-based banks inside and outside the Sudan?

Like other IBs, those in Sudan do not undertake interest-based transactions. No IB has any joint investment project with non-Islāmic banks. This is, however, an obstacle to the growth and expansion of IBs. Therefore it remains a question for the managers and the *Shari'a* Supervisory Boards (*SSB*) of IBs to find financial instruments which are legitimate in the view of Islāmic laws and at the same time are acceptable to the traditional banks.

By the same token, their hope for non-Islāmic banks to hold funds with them remains limited as long as IBs do not give interest on these deposits. Here unless IBs improve their work and become competitive, no traditional bank or financial institution will place money with them. Thus, they lose a great part of the market share that they could attract were they to pay an interest rate.

IBs' funds will not be placed in term deposits, but merely on call. However, call money is capable of yielding interest, and as the IBs themselves would not pay interest on such deposited funds, they agree that they are unlikely to be beneficiaries when making such deposits.

However, the question of dealing with the traditional financial sector is a vital one because IBs in the Sudan are considering a more international approach to their business. All IBs are involved in investing part of their capital abroad. The reasons for this are profit, safety, to facilitate financing their transactions abroad like imports, and to get foreign exchange returns. Furthermore any foreign investment is not included in the ceiling of each bank. Therefore, unless IBs discover the appropriate financial tools, they will not be able to develop their business relations with the traditional financial system. At present IBs have only subscribed to the Islāmic Banks' portfolio kept with the Islāmic Development Bank in Jeddah. Apart from that, the percentage of their foreign investments is very low, concentrated with other IBs in the Gulf States and Europe.

7.9 Portfolio Management:

One of the elements liable to affect the market share of IBs is the way they manage their portfolio.

The portfolio management problem of IBs is a sufficiently important issue. The objectives of an Islāmic bank were taken to be (Bashir, B. A., 1982):

- (1). maximisation of returns to depositors
- (2). achievement of sufficient returns to depositors
- (3). minimisation of the bank's risk of loss.

It was concluded that to achieve such objectives, the management of an Islāmic bank would have to make its decisions on the following variables:

- (i). The proportion of each type of asset in its portfolio,
- (ii). The profit-sharing ratio to short-term depositors
- (iii). The premium to long-term depositors.

However, for IBs in the Sudan there is no such classification of deposits between short-term and long-term. Moreover, with the stringent credit ceiling policy adopted by the central bank, IBs are facing the constraints of over-liquidity, and have halted investment deposits because there are no investment outlets.

IB managements face the problem of determining how much would be the share of depositors and shareholders in profit. The issue has considerable ideological implications since,

- firstly, no system is adopted for offering a premium for long-term deposits, but IBs give depositors (holders of investment deposits) a higher percentage of profit;
- secondly, no Islāmic bank offers different investment accounts characterised by different risks, a service which is needed since depositors have no institutionalised influence on the management decision. IB managers think that depositors are changeable over time, some new depositors come to deal with the bank,

while another group withdraw their deposits. Thus it is difficult either to offer different investments characterised by different risks or to allow depositors to have institutionalised influence on the management decision,

- thirdly, all IBs manage their portfolio in the same way, so that depositors' funds and shareholders' funds are used to fund the same projects, be they of low or high risk. This might be unfair to depositors whose money is used in funding high-risky projects. There is no differentiation between long, medium or short-term deposits.

If market share is assumed to be affected by the dealing of IBs with traditional banks and by the way they manage their portfolio, it is affected more by the way IBs distribute profits.

7.10 Distribution of Profit:

All IBs follow the same procedure: depositors take their share from gross profit, while the remainder, the net profit, is distributed among shareholders according to the rate of return specified by the bank's management.

However, in calculating gross profits, IBs deduct any income generated without direct recourse to depositors' funds from the gross profit that are liable for distribution between depositors and shareholders. That is to say, depositors take their share from investment returns and returns from the buying and selling of currencies. Thus, return on investment deposits is reached by applying the following criteria:

Firstly, finding out the operation (utilisation) period for each of the following items to get their respective weight:

Capital less fixed assets and shares in subsidiary companies,

Investment deposits minus 12.5% cash reserves deposited with the Central Bank,

Current deposits less 40% cash reserves,

Saving deposits less 40% cash reserves.

Secondly, dividing total revenue generated from investment operations and foreign exchange transactions by the respective weights of the aforementioned items, in order to find out the total income pertaining to each item.

Thirdly, the gross return on investment deposits will then be discounted by 30% representing the bank share against managing investment operations. The remaining 70% will be distributed among investment deposit holders by the end of the financial year.

The point is that there is no specific criterion followed in determining the rate of return on deposits, and therefore the rates of profitability of investment deposits³¹ vary from one bank to another. Table 7.18 below shows these rates for the financial years 1985 and 1986.

Table 7.18: Investment Deposits: Rate of Profitability

Name of bank	Rate of profitability (%)	
	1985	1986
Islāmic Co-operative Development Bank	11	8
FIBS	11	8
Taḍāmon Islāmic Bank	9	10*
Islāmic Bank for Western Sudan	6	5
Al Baraka Bank	n.a.	n.a.
Sudanese Islāmic Bank	n.a.	n.a.

* A rise is due not to an increase in profit but to fall in deposits.

Source: as calculated from IBs' balance sheets.

It is clear that the rates of profitability of investment deposits have declined for all IBs. If holders of investment deposits expect a lower rate of return on their deposits every year, they will clearly reduce their balances. This tendency is more likely to happen under the current circumstances of inflationary pressures

³¹ Rate of profitability is calculated as share of holders of investment deposits divided by total investment deposits.

prevailing in the Sudan. Therefore if IBs are not competitive in the rates of return they distribute among depositors, they will lose part of their deposit market share.

There are conditions which entitle depositors to profits such as minimum contracted periods and minimum balances in deposit account. The period is almost three months for investment deposits.

These conditions which entitle one to profit might be at the expense of those depositors or petty savers who have not got the minimum balance and/or who need to withdraw from their investment accounts to meet contingent spending before the three months elapse. Hence these savers were unable to open investment accounts, since even if they could, they would not be entitled to profits. Hence these conditions affect negatively the market share of IBs.

It is, in fact, not enough to know about, as explained above, the procedure of distributing profit among depositors and the implication of this on market share, it is as well important to see the share of shareholders in profits and the guarantee of IBs' managements to safeguard them against bankruptcy.

Firstly, the legal and general reserves are deducted from the net profits (of shareholders) and not from gross profits (of depositors and shareholders). This practice is fair since the depositors have no stakes in these banks. Therefore the bank should not deduct from gross profits to build up general reserves.

Secondly, in order to safeguard shareholders against bankruptcy, IBs hold legal and general reserves higher than the normal level. That is, instead of 5% for the former and 10% for the latter, IBs hold 10% and 25% respectively. General reserves are built till they reach 100% of the bank's capital. The procedure of taking higher legal and general reserves benefits the shareholders and safeguards their position in case of bankruptcy. In this regard, IBs are enhancing positively their market share since they safeguard shareholders against bankruptcy.

Thirdly, it is not enough that shareholders are safeguarded only against losing part or all of their shares' value; they have to earn higher return on their shares. This is important for the maintenance of market share and it has a direct effect on shareholders' willingness to increase their holding of shares. Table 7.19 below shows the ratio of distributed profit to shares (RDPS) by IBs.

Table 7.19: IBs: RDPS (1985-1987)

Bank name	RDPS (%)		
	1985	1986	1987
FIBS	16	6	1
Taḍāmon Islāmic Bank	6	2	2
Sudanese Islāmic Bank	n.a.	6	2.7
Islāmic Co-operative Development Bank	n.a.	12.6	33.5
Al Baraka Bank	n.a.	4	3.8
Islāmic Bank for Western Sudan	7	7	3

Source: as calculated from balance sheets of IBs.

Shareholders of all IBs, except the Co-operative Development Bank, experienced a decline in shares' profit. For instance, FIBS distributed 16% in 1985 and in 1987 shareholders had only 1% as a profit per share.

This decreasing tendency discouraged shareholders and resulted in delayed payment of the subscription that should be paid by them. Thus if one looks at the paid-up capital of IBs, will notice that there is almost no change over the years 1985-1987.

There is a very slow growth of paid-up capital of IB as returns were low. If, however, there were a money market in the Sudan, shareholders would by all means sell their shares in these banks.

- **Summary**

Rates of profit on both deposits and shares affected the market share of IBs. Both depositors and shareholders faced declining rates of return in the last three years. This low return, coupled with a high inflation rate, discouraged both depositors from holding investment accounts and shareholders from responding positively to calls for payment of price of shares subscribed for. It is consequently quite noticeable that investment deposits and paid-up capital of IBs grew slowly in the last three years.

It is, therefore, highly necessary that IBs maintain their market share by being competitive in returns on both investment deposits and shares.

The last factor in this set of determinants of market share is the extent to which IBs are capable of extending their branches.

7.11 Management and Set-up of Branches:

There is a problem regarding branch expansion which affects negatively the market share. IB managers think that the reasons for slow expansion of their branches are security, communication difficulties, the sluggish procedure of the Central Bank to grant licences and the difficulty in raising capital. Such problems affect the growth of IBs and their market share as organised saving mobilisers.

One of the serious problems facing IBs in establishing and managing branches is the lack of communication between branches in rural areas. Nearly all branches in rural areas are detached from the head-quarters. So there is a real problem of managing these branches, giving them directives, exchanging news of market conditions and prices with them, or changes in internal policies or policies of the Central Bank.

Another serious problem faced by branches, especially in rural areas, is the reluctance of bankers to work in remote areas far from big cities. Moreover, the turn-over of bankers is high even among bank employees in urban areas. This high turn-over is attributed to inadequate salaries and the high prices of even the most basic needs.

Yet, IBs do have branches in rural areas and the deposits of these branches are an important means of financing operations in urban areas. The point is that depositors in rural areas are poor compared with those in urban areas. Most of them are not investment account holders but have current accounts only. Therefore it might be unfair to use their savings and not to give them a share of returns. IBs could, by distributing profits, allow rural areas branches some privileges such as giving special profit margins to depositors in rural areas, or allowing some funds from total profits, to give some incentives, even in kind, to depositors in remote and backward areas. In this way IBs can mobilise more of the stagnant resources

in rural areas and increase their market share by penetrating these areas instead of competing with other banks for the same group of depositors in rural areas.

Chapter VIII

The Role Of Islāmic Banks In The Sudanese Economic Development

8.1 Introduction

Chapter five discussed the problems facing the Sudanese economy. Chapter six showed the nature and development of financial institutions in the Sudan, the degree of financial repression, and the possibility for financial institutions to play a vital role in monetising the economy. The chapter also contained a detailed analysis of the monetary policy and how it developed and become stricter over time, and the effect of this on the credit facilities of commercial banks.

As mentioned in chapter seven, the main aim of this work is to examine the role of IBs in economic development. Chapter seven discussed the first aspect of this role, i.e. the mobilisation of stagnant resources. It showed the magnitude of these resources in the form of paid-up capital and deposits; it also showed the detrerminants of the magnitude and structure of these resources.

This chapter discusses the second aspect of the role of IBs in economic development, i.e. the financing of medium-and-long-term investment projects.³² The determinants that are assumed to have affected the contribution of IBs are:

1. The magnitude and structure of resources available to IBs
2. The character of demand (investors' behaviour) for productive investment projects.
3. Management attitude
4. the attitude of the authorities
5. The nature and character of Islāmic modes of finance.

³² In order, however, to complete an assessment of the role of the IBs in economic development, the experience of FIBS in financing small crafts firms will be assessed in the following chapters.

The contribution made by the IBs will be examined within a structural-functional framework to see whether or not these IBs have played the role expected of them in development financing, given their objectives and the circumstances in which they find themselves.

The chapter comprises sections covering the following subjects:

- Banks and economic development: theoretical framework
- medium-and-long-term investments financed by the banking system and IBs in Sudan
- medium-and-long-term financing: possible determinants.

8.2 The Role of Banking

Economists have expressed a variety of opinions on the effectiveness of banking systems in promoting or facilitating economic development. Schumpeter, the first modern economist to study the relationship, regarded the banking system as one of two key agents (the other being entrepreneurship) in the whole process of development. Writers like John G. Gurley, on the other hand, think that banking systems as intermediaries are not highly essential to the growth process. However, Cameron says that

'it is safe to say that the true importance of the banking function lies somewhere between these two extremes', (Cameron, R., 1972, p. 7).

The banking system is one of many institutions that influence the economy and affect its performance for better or worse. Others are government, religious institutions, the educational system, ethics ... etc. As an economic institution, the banking system might be expected to be more directly and positively related to the performance of the economy than most non-economic institutions; however, this cannot be taken for granted. Religious institutions, for example, may have a more powerful influence on the economy, either positive or negative, than the banking system. Certainly, this is true of the institution of government, which has the power to shape and control the banking system.

A banking system may make a positive contribution to economic growth and development, but its effect may be offset by other factors such as unfavourable resource endowments, or unhelpful government policies. Conversely, if other factors are sufficiently favourable, even a bad banking system may not hinder growth absolutely. What can be asserted is that any given banking system might, with different policies, be made more or less effective in its contribution to economic development.

It may be worthwhile to review briefly the functions of a banking system. The first and essential function of any banking system is to act as an intermediary between savers and persons able and willing to borrow. What distinguishes banks from other financial intermediaries is that they alone furnish part or all of the means of payment or money supply. They do this either by issuing their own promises to pay or by holding and transferring the monetary deposits of the public. A third possible function, although not inherent in the definition of a banking system, is the provision of entrepreneurial talent and guidance for the economy as a whole. That is, instead of restricting themselves to a purely intermediary function, bankers may actively seek out and exploit profitable undertakings in manufacturing, commerce, or any other productive activity. This banking function is, and has been, of great importance in developing economies.

The way in which banks perform these functions in underdeveloped and developing economies may well determine the degree of success of the development effort: (i) as intermediaries, they may rigorously seek out and attract reservoirs of idle funds which will be allocated to entrepreneurs for investment in projects with a high rate of social return, or they may fritter away investment possibilities with unproductive loans; (ii) as creditors and providers of means of payment, they may redirect real resources into more productive activities, or, as a result of government pressures, they may flood the economy with inflationary dealings; (iii) as potential entrepreneurs, they may set the country on the road to continuing growth, or they may waste its resources in uneconomical or fraudulent activities.

Historically, banks have contributed to economic growth in three different ways. Firstly, as intermediaries between savers and borrowers and in some cases as creditors of means of payments, they provide credit for both fixed and circulating capital

for commercial and industrial enterprises, and frequently for agriculture as well. Secondly, banks have played a direct entrepreneurial role by founding new enterprises, providing them with finance and participating in their direction. Finally, as providers of all or part of the means of payment within a community, banks have facilitated the division of labour within a society that is necessary for higher levels of productivity than are found in closed subsistence economies, (Cameron, R. 1970).

8.3 Banks & Economic Development: A Theoretical Framework

One of the most original theories relating the banking system to economic growth is that of Josef Schumpeter. For Schumpeter, economic development is a process resulting from a new technique of production, and those who carry this are called entrepreneurs. The entrepreneur is not a businessman, a manager or a capitalist; he is an individual who sees possibilities for profit in the new combination and who then borrows the financial resources necessary to carry it out. He borrows from banks, who create new means of payment to enable the entrepreneur to have a command over factors of production. Thus, in Schumpeter's theory, banks occupy a key role in the development process, (Schumpeter, J., 1934).

Although Schumpeter's theory remains one of the best guides for the study of banking and economic growth during the earlier stages of industrialisation, its major shortcoming involves the formal relationship of the banking enterprise to the innovating entrepreneur. According to Schumpeter, the bank is not directly involved in the economic process, and the bank is to receive the stipulated interest rate, without being able to share in the profits, (see Chapter III). This also implies that the bank deals essentially in short-term 'self-liquidating' loans, not in promotional investment. But there are numerous instances in the history in which banks have acted as innovating entrepreneurs.

One of the most widely discussed explanations of the role of banking in the process of industrialisation (development) is that of Alexander Gerschenkron. Although the banking system is by no means the only element in Gerschenkron's explanation of the distinctive pattern of industrialisation in various European countries, he holds that it does play a key role at certain stages of the industrialisation process. In his approach to the problem of understanding European

industrialisation in the nineteenth century, he views the role of banks in a different light than Schumpeter does. For Gerschenkron, although the role of banks is an important one, it is definitely subsidiary to the initial conditions existing at the onset of industrialisation, i.e. the varying degree of 'backwardness'.

Gerschenkron distinguishes three 'typical cases' with respect to capital and entrepreneurship: England, the pioneer; Germany, an area of 'moderate backwardness' and Russia, an area of 'extreme backwardness'.

According to Gerschenkron, England began to industrialise with relatively small-scale enterprise, requiring little capital on specialised entrepreneurship. Initial capital requirements came from the entrepreneur's own savings or from those of his relatives, friends, customers and suppliers. No outside agency was needed to supply either capital or entrepreneurship, because the enterprise itself was the source of both.

But when Germany began to industrialise, technology and markets became more complex; the optimum scale of plants was larger, requiring larger blocs of investments; as a 'moderately backward' area, Germany had fewer potential entrepreneurs and less liquid capital. As a result, the banking system became the prime source of both capital and entrepreneurship.

In Russia, which was more backward than Germany, not even the banking system was adequate to the task of providing capital and entrepreneurship for industrialisation. There the Russian government played the major role in initiating large-scale, capital-intensive industries in the late 1880's and 1890's, (Gerschenkron, A., 1962).

However, is this explanation applicable to other countries? More specifically, is it accurate for, and does it explain, the true situation in the countries for which it seems most appropriate?

Cameron (1972) criticises Gerschenkron's explanation on the following grounds:

Firstly, Gerschenkron misunderstood the nature of the English banking system. The relatively small-scale of English country banks during the classical industrial

Revolution, and their normal reluctance to make long-term investments in industrial enterprises, was due to legislation and not to the choice of either bankers or industrialists. Laws that limited banking partnerships to six persons and forbade them limited liability determined the structure of the English banking system and thus to some extent limited its functions. Even so, there were numerous instances in which banks made long-term commitments to industrial enterprises.

Secondly, Gerschenkron's characterisation of Germany's banking system is more correct than his description of the English system. Yet it, too, is debatable. On the one hand, he exaggerates the shortages of entrepreneurship and capital in Germany; on the other hand, he overemphasises the spread of banks and says that

'German banks accompanied their clients from the cradle to the grave, from establishment to liquidation', (Gerschenkron, A., 1962, p. 14).

Thirdly, the Russian government had played a prominent role in the economy but with few beneficial consequences. The policy shift favouring economic modernisation did not really begin to show tangible effects until the 1880's, that is until the banking system was already in a vigorous phase of development.

However, because the hypothesis has been employed to explain the peculiarities of particular cases, it cannot be generalised. Moreover, Gerschenkron's organising principle, the 'degree of backwardness', cannot be measured and thus it is not an operational concept.

G. Gurley and E. Shaw have developed another model that allows for growth in both the financial system and the economy as a whole. The model delineates clearly the role of financial intermediaries (including banks) as both buyers and sellers of financial assets (including money) of varying degrees of security, liquidity, rentability etc., (Gurley, G. and Shaw, E., 1964).

The work of D. R. Hodgman also discusses the role of banks in economic development. Although it is concerned with banking practices in the United States, the work is regarded as helpful in considering the role of banks, (Hodgman, D. R., 1963).

Whether or not the banking system makes a positive and substantial contribution to economic development does not depend primarily upon the personal qualities of the bankers, although these qualities cannot be overlooked. The 'structural' characteristics of the system, and the laws, regulations and customs that govern its behaviour, will normally be far more important determinants of its effectiveness. This approach is advocated by Rondo Cameron, but was first perceived as early as 1913 by officials of the J. P. Morgan & Company, who declared that the concentration of financial power in the United States was due not to the purposes and activities of men, but primarily to the operation of the antiquated American banking system. The experience of IBs with development financing in the Sudan will be evaluated using this structural-functional approach. The point here is that the banking system is an integral, interdependent part of the total economy, and without a demand for its services, it would obviously not exist. But given that it does exist, its structure will be shaped very largely by the actions of the political authorities in the form of laws, decrees, regulations and by more direct participation such as government ownership.

What follows is an account of the contribution of commercial banks and IBs to development financing and an evaluation of this contribution by accounting for its determinants as assumed above.

8.4 Banking System and IBs: Development Financing

With the advent of political independence in the Sudan, the argument against commercial banks, which were branches of foreign banks, was that these banks concentrated on financing the foreign sector to provide industries in the developed world with raw materials and to seek market outlets for their industrial products in the developing countries. This argument was one of the excuses for nationalising commercial banks in the Sudan in the early 1970's in order that the state might control the foreign sector and redirect total resources mobilised by these banks to social and economic development programmes, (see Chapter VI). Thus, in 1974, when the open-door economic policy was launched and foreign banks were allowed to set up branches or to establish joint and private banks, it was stipulated that banks granted licences should play an effective part in economic and social development.

Under these circumstances it is a must for IBs, in order to start their banking activities, to declare their intention to participate in financing economic development. They must also prove on a practical level that this contribution would be more effective and would operate through different modes of finance. Therefore the responsibility of IBs to participate in development, and the inclusion of this promise in their objectives and policies, originate from: (i) their legal responsibility towards the central bank to fulfil the licence's conditions imposed on them to start Islāmic financing in the Sudan; and, (ii) their moral responsibility to society in general and to those who deal with these banks since IBs would have a different approach to financing economic development by attracting new petty savers and investors. In the past such individuals did not deal with banks since they rejected interest-based transactions.

One of the conditions for granting licences to establish joint banks (including IBs) and foreign banks is that the bank should concentrate on medium-and-long-term financing.

The 1986 credit policy stated that the medium-term financing is that which would be liquidated within a period of more than one year and less than five years. Long-term financing is for a period of at least five years. The policy stipulated that the productive sectors include agriculture, industry and transport; in addition, the participation in the capital of companies and corporations which work in the field of agriculture, industry and transporting crops, (see the credit policy described latter in this chapter).

Now, what is the contribution of the banking system in general, and the IBs in particular, to the funding of productive sectors?

- The Allocation of Finance: Consumption versus Investment

The developmental impact of any given supply of credit obviously depends upon the wisdom and efficiency with which it is allocated. Many have suggested that in the Sudan, in the 1970's, an excessive quantity of finance led to unwise resource allocation, emphasising 'speculative' investments in real estate. Conversely, the restricted quantity of finance in the 1980's also involved a shift in the composition of bank credit towards short-term , strictly commercial loans. It is clearly

necessary that one keep in mind the underlying conditions of economy-wide supply and demand for credit when discussing the allocation of IBs' credit to specific sectors or activities.

The question is this: did credit allocation by IBs accelerate economic growth by raising the proportion of total output devoted to investment rather than consumption? For the economy as a whole, the evidence available permits only the most impressionistic answer to this broad question. Statistics on rates of savings or investment for the various sectors of the economy are simply not available. The typical institutions of the Sudan spend their incomes or borrowed funds on both consumption and investment. Farmers and other businessmen rarely separate 'business' from 'personal' expenses in their book-keeping. Records of financial institutions contain similar ambiguities.

Despite the lack of quantitative evidence, some guesses can be made about the impact of IBs' finance on consumption versus investment. The type of collateral most acceptable for IBs loans (and commercial banks loans in general) – mortgages on land, buildings – were biased in favour of loans for investment. Most of the indirect finance of IBs and other intermediaries was at least intended to support investment spending. But what type of investments? This crucial question will be answered in the next section, where the structural-functional approach is used to evaluate the experience of IBs with medium-and-long-term finance.

8.4.1 Banking System

Table 8.1 shows the credit facilities extended by commercial banks over the decade 1978-1988.

It is obvious that there has been only a slow change in the structure of credit facilities by commercial banks over the period under review. The percentage of short-term financing declined from 85% in 1978 to 64% in 1988. The percentage of medium-and-long-term financing increased from 15% in 1978 to 36% in 1988. Although, however, it might appear that the share of medium-and-long-term investments doubled over a decade, the statistics reveal that most of this finance was directed towards participation in companies and corporations that are commercial in nature and have little concern about development investments.

Table 8.1: Commercial Banks: Credit Facilities (1978/88) (LS. million)

Years	Short-term loans	%	medium-term & long-term loans	% -	Total
1978	291.1	85	52.1	15	343.2
1979	365.2	79	95.7	21	460.9
1980	462.75	78	130.4	22	592.9
1981	611.1	79	166.4	21	777.5
1982	899.2	79	243.3	21	1142.5
1983	1001.7	73	375.2	37	1376.9
1984	1215.9	72	570.8	28	1776.7
1985	1305.2	68	570.6	32	1875.8
1986	2002.9	72	634.7	28	2612.39
1987	2999.8	79	793.0	21	3792.8
1988	3566.6	64	1986.0	36	5552.6

Table 8.2: Medium & Long-Term Credits Structure (1978/1988) (LS. million)

Years	Capital investments	%	Participation & other investments	%	Total
1978	40.8	78	11.3	22	52.1
1979	81.6	85	14.1	15	95.7
1980	114.6	88	15.5	12	130.4
1981	138.9	83	27.6	17	166.4
1982	185.3	76	57.6	24	243.3
1983	56.5	15	318.7	85	375.2
1984	131.1	23	439.7	77	570.8
1985	142.5	25	428.3	75	571.0
1986	160.6	25	474.1	75	634.7
1987	170.0	21	623	79	793
1988	357.5	18	1628.52	82	1986

Source: Department of Statistics and Economic Researches, Bank of Sudan, as amended

Table 8.2 above shows the structure of medium-and-long-term loans. It appears that there is an increasing tendency for commercial banks to concentrate on participation in companies rather than on direct investments. Although capital investments were substantial up to the early 1980's, they have been declining and fluctuating over time, being only 25% in 1986 and as low as 18% of the total in 1988. Conversely, participation in financial corporations and subsidiary companies increased from 22% in 1978 to 82% in 1988.

Thus, in the banking system as a whole, there was a reluctance to participate in development financing. What was the attitude of the IBs?

8.4.2 IBs: development financing:

It was mentioned in Chapter V that the government development policy recognises the private sector and its role in development financing, and that there is no obstacle for IBs to finance development. Moreover, it was also mentioned that the private sector has grown over time and its contribution to total investments has increased; however, the major share of its investments went to housing. To what extent did IBs contribute to the productive investments?

Table 8.3 reveals the structure of credit facilities for the banking system as a whole and for IBs over the period 1980-1988. Medium-and-long-term credits for IBs grew by 25% while for the whole banking system the growth rate was 14%. The share of IBs in total credits in the economy increased from 6% in 1980 to 14% in 1984; it then began to decline, falling to 11% in 1987. Their share of medium-and-long-term financing increased from 4% in 1980 to 10% in 1984, reaching its maximum level in 1987 at 18% after which it declined to only 10% in 1988.

Although IBs account for 20% of the banking deposits, their share in credit extension is, over time, far less than their market share. This is especially true in the case of medium-and-long-term financing. Medium-and-long-term financing grew by 14% for the banking system as a whole over the period under consideration. Excluding IBs, this growth rate was 11.4%; in other words, IBs added only 2.6% for the growth of real capital investments.

Table 8.3: IBs & Banking System: Structure of Credit Facilities
(L.S. million)

Years	Government banks			Foreign banks			IBs			Banking system			Grand Total		
	short	M & L*	Total	short	M & L	Total	short	M & L	Total	short	M & L	Total	short	M & L	Total
1980	366.5	123.6	490.1	43.8	0.3	44.1	21.0	1.3	22.3	31.2	5.2	36.4	462.5	130.4	592.9
1981	455.2	161.7	616.9	71.8	0.3	72.1	32.8	2.0	34.8	51.3	2.4	53.7	611.1	166.4	777.5
1982	576.4	235.0	811.4	119.1	0.7	119.8	65.4	2.6	68.0	138.3	5.0	143.3	899.2	243.3	1142.5
1983	609.5	356.8	966.3	157.2	5.3	162.5	91.7	2.3	94.0	143.3	10.8	154.1	1001.7	975.2	1376.9
1984	686.9	456.0	1142.9	150.7	49.9	200.6	171.6	6.0	177.6	196.7	58.9	255.6	1215.9	570.8	1776.7
1985	769.4	455.9	1225.3	146.5	49.9	196.4	205.0	10.1	215.1	184.3	54.7	239.0	1305.2	570.6	1875.8
1986	1376.3	469.5	1845.8	128.6	52.7	181.3	250.2	20.9	271.1	247.7	91.1	339.3	2002.9	634.7	2637.5
1987	2287.4	543.1	2830.5	137.8	49.5	187.3	281.0	59.0	339.0	294.6	141.4	436.0	2999.8	793.0	3792.8
1988	2537.7	639.6	3177.3	198.9	41.1	240.0	360.2	57.8	418.0	469.9	199.7	669.6	3566.6	1986.0	4504.9

Source: Bank of Sudan Annual Reports

* M & L = medium & long term credit facilities

When IBs were founded, it was declared that their objectives were developmental. The objectives of FIBS included:

(i) To help implement local development plans designed to accelerate growth in different regions of the country.

(ii) To participate with small investors in their productive projects whether these are agricultural, industrial or handicrafts projects.

(iii) To provide immediate help for small investors under emergent conditions that necessitate spending above the normal level.

In the articles of the Tadamon Islāmic Bank, it is stated that the bank would undertake all banking business, and all financial, commercial and investment dealings, in addition to participating in development projects in agriculture, industry and other sectors. Special concern was to be given to economic projects of medium-and-long-term nature.

The objectives of the Sudanese Islāmic Bank focus more on small craftsmen and investors, and on helping to improve the economic conditions for public and private investments.

All these objectives imply a direct and specific responsibility on the part of IBs to play an effective role in social and economic development by adopting modes of finance that are different from those adopted by traditional banks. But what IBs have accomplished on the side of development financing is still far less than what was first declared and expected. It is apparent that IBs have concentrated on short-term commercial activities to maintain their existence in the market. IBs wished to convince their depositors and shareholders that they were capable of generating high returns and profits. There can be no doubt that the policy of achieving high profits is important for the success of IBs or any profit-making institution, but this should not be a permanent policy. The policy of convincing depositors and shareholders should be transitional, and IBs should redirect their objectives towards other real productive activities.

There can be no doubt that the development goals adopted by IBs coincided with the needs of the national economy. IBs have been expected to extend finance

to small investors, producers, handicrafts and small industrialists, particularly those in rural areas.

Although several years have passed since the advent of IBs in the Sudan, during which time IBs have mobilised fairly adequate financial resources, the fact remains that they still concentrate their investments on short-term commercial activities as do other commercial banks. Short-term financing by IBs amounted to 86% of their total investments in 1980; the percentage decreased to 70% in 1988. These percentages exceeded those for the whole banking system which were 78% and 64% in 1980 and 1988 respectively, (Table 8.3). The percentage of short-term financing exceeded 95% for some IBs in 1986, (Table 8.4).

Table 8.4: IBs: Investments Distribution for 1986 (LS. million)

	Short-term investments	%	medium-term & long-term investments	%	Total
Sudanese Islāmic Bank	49.74	89	5.94	11	55.68
Al Baraka Bank	44.44	88	5.92	12	50.36
Islāmic Bank for Western Sudan	25.92	96	1.08	4	27
FIBS	130.41	78	27.94	22	127.35
Tadāmon Islāmic Bank	12.64	53	11.34	47	23.98
Islāmic Co-operative Development Bank	66.43	91	7.17	9	73.6
Total	329.58	82	59.39	18	357.97

Source: IBs' Reports, as calculated by the author.

On the other hand, the medium-and-long-term financing, which never exceeded 18% of the banking system's long-term investments throughout the period, (see Table 8.3) was for the most part participation in capital of banks and financial institutions and subscriptions in subsidiary companies. These subscriptions amounted to 86% of the medium-and-long-term financing by IBs in 1986, (Table 8.5).

What attracts attention here is the direction of financial resources to investments outside the country. For instance, FIBS directed 53% of its medium- and long-term financing to other financial institutions. Almost 50% of this was subscriptions to financial institutions outside the country, while the Taḍāmon Islāmic Bank placed 47% of its medium-and-long-term investments abroad. However, all IB managers replied to the question addressed to them that investment through subsidiary companies is important.

Table 8.5: IBs' Distribution of Medium-Term & Long-Term Investments for 1986
(LS. million)

	<i>Participation in</i> *	%	<i>Participation in</i> *	%	<i>Others</i> †	%	Total
Sudanese Islāmic Bank	0.900	15	4.95	83	0.09	2	5.94
Al Baraka Bank	-	-	4.38	74	1.54	26	5.92
Islāmic Bank for Western Sudan	-	-	0.52	48	0.56	52	1.08
FIBS	14.92	53	10.60	38	2.42	9	27.94
Taḍāmon Islāmic Bank	5.34	47	6.00	53	-	-	11.34
Islāmic Co-operative Development Bank	-	-	1.07	15	6.10	85	7.17
Total	21.16	38	27.52	48	10.72	14	59.4

* banks and financial institutions; * subsidiary companies; † other participations

Source: IBs' Reports, as calculated by the author.

Referring one more to Table 8.5, the remaining balance of medium-and-long-term investments which amounted to Ls. 10.72 millions by the end of 1986 (14%), was the amount which represented a contribution to direct investment of a productive nature. It is worth mentioning here that the dominant share was that of the Islāmic Co-operative Development Bank, with some 40% of the total medium-and-long-term investments by IBs. In general, for all IBs the share of medium-and-long-term corporate financing in total financing is regarded as low. If one goes beyond the short-term financing of working capital, the financing was provided not on the basis of participation but of *murābaha*.

When examining further the contribution of IBs to the funding of productive activities, one realises the rather limited contribution of the IBs. For instance, the financing of small handicrafts never exceeded 2% of the total investments extended by FIBS (see Chapters IX and XI). The total sum extended to small investors and handi-crafts was Ls. 18 millions over the period 1980-1986. Most of this finance was commercial, usually for the selling or retailing of equipment and machinery.

The Sudanese Islāmic Bank extended no more than LS. 2.49 million to small farmers in rural areas in 1986. These amounts represent only seasonal financing to small producers. The Taḍāmon Islāmic Bank directed its medium-and-long-term investments to participation in financial institutions and subsidiary companies.

- Summary:

It is clear that the contribution of IBs to the real productive activities is insignificant. However, from a broad spectrum of possible forms of interaction between the financial sector and the other sectors of the economy that require its services, one may isolate three type-cases:

(a) The case in which inadequate finance restricts or hinders industrial and commercial development;

(b) The case in which the financial system is purely permissive and accommodates all 'credit-worthy' borrowers;

(c) The case in which financial institutions either actively promote new investment opportunities or encourage applicants for finance to come forward, provide them with advice and extra services, etc.

Looking at the financial sector and the other real sectors of the Sudanese economy, one notices that all three cases are applicable to the Sudan. Firstly, inadequate finance is restricting industrial and commercial development. Most, or all, productive units lack finance. Secondly, almost all the financial institutions concentrate on financing the 'credit-worthy' firms, especially those in urban areas, and extend little credit to the financially-starved productive units, especially those in rural areas. Thirdly, financial institutions neither promote new investment opportunities nor encourage applicants for finance to come forward and provide them

with advice and extra services.

The situation is more or less the same for IBs. As mentioned earlier in this chapter, of the many possible determinants of the banking role in economic development, the author assumes that four are of paramount importance: (i) the size and nature of the liability side of IBs, i.e. the financial resources available to them; (ii) the strength and nature of demand for financing long-term projects, i.e. the attitude of investors; (iii) the attitude of management; and (iv) the behaviour of authorities towards banking in general and IBs in particular. There is, however, another factor which may be regarded as being peculiar to IBs and which affects their role in economic development, namely the nature of Islāmic mode of finance.

From the above, it is clear the contribution of the banking system as a whole and the IBs in particular to the finance of development is insignificant. Given the role that IBs play (the function) in financing real productive sectors, what is the impact of the determinants, i.e. the structure, on the role of IBs? In other words, what is the impact of a structural-functional relationship?

8.5 Development Financing: Possible Determinants:

As mentioned earlier, one would expect different responses from profit-motivated bankers, given the different objective economic opportunities. This may be the reason why IBs have tended to concentrate on short-term financing. But there may be other possible reasons: (i) the size and nature of the liability of IBs, i.e. the financial resources available to them, (ii) the strength and nature of the demand for financing long-term projects, i.e. the attitude of investors; (iii) the attitude of management; (iv) the behaviour of authorities towards banking in general and IBs in particular; and (v) the impact of Islāmic mode of finance.

8.5.1 The magnitude & structure of available resources:

This is the first perceived determinant of contribution to economic development. If IBs cannot obtain adequate investible resources, they will not be capable of funding any productive investment projects. The question here is, can the insignificant contribution to development financing be attributed to the shortage of resources available to IBs?

In attempting to assess the importance of Islāmic banking in economic development, it would be helpful to have a quantitative estimate of the size of the Islāmic banking sector in relation to other banks and to the economy as a whole. Referring back to Table 7.2 in Chapter VII, it is worth noting the high average capitalisation.³³ The average capitalisation of the IBs is 29.6%, which is higher than that of both commercial banks (18%) and government banks (15%). Moreover, IBs accounted for 41.7% of the total capital of the banking system. These figures indicate that IBs are able to attract savings in a form of equity (capital and reserves).

Obviously, commercial banks do not operate primarily on their own capital. One of the distinctive features of banking as a business is that banks mobilise the temporarily idle funds of others and persuade the public to accept their own liabilities. Thus the total deposits of the IBs are a more indicative measure of its importance in economic development than is its equity capital.

Compared to the commercial banks, IBs account for between 16% and 18% of the total deposits of all banks, (Chapter VII, Table 7.4). Moreover they are characterised by a favourably high average capitalisation, (Table 7.2). This is a fairly significant ratio.

Given the relative size of the banking sector, in terms of the ratio of total assets (or liabilities) of the banking system and IBs to the total national wealth it is clear that this relative size is by no means insignificant. Table 8.6 shows banks' assets and national income over the period 1980-1987.

What is clear from the table is the importance of the banking sector in general to the economy, and its vital role in economic development. The ratio of banks' assets to national income increased from 31.6% in 1980 to 41.8% in 1983 and 52.8% in 1985. IBs account for almost one-fifth of commercial banks' assets and nearly one-tenth of the national wealth. This ratio is relatively high and the banking system is in a position to play a major role in the development finance.

What can be understood from the above discussion is that IBs are able to mobilise savings (in the form of capital or deposits) and that these resources can

³³ Average capitalisation equals banks' capital divided by the number of banks.

be used in funding economic real productive sectors. Thus in this respect one can say that the size of IBs in relation to the economy is not negligible, if one takes the ratio of bank assets to national income as a measure. This as Cameron says

'is the best practical measure of its (i.e. the banking sector) efficiency in the performance of one of its two essential functions, securing control of disposable funds for investments', (Cameron, R., 1967, p. 300). But have IBs used these financial resources to fund economic development?

Table 8.6: Banks' Assets & National Income (1980/87) (LS. million)

YEARS	Banks' assets (1)	National income (2)	(1)/(2) %	IBs assets (3)	(3)/(1) %	(3)/(2) %
1980	1305	4122.8	31.6	-	-	-
1981	1792.9	5431.3	33.0	-	-	-
1982	2496.7	6651.0	37.5	-	-	-
1983	3486.9	8330.8	41.8	-	-	-
1984	4178.4	10403.1	40.0	791.1	19	7.6
1985	6217.3	11777.0	52.8	1053.5	17	9
1986	7373.6	16425.3	45.0	1182.0	16	7.2
1987	9883.5	20763.8	47.6	1696.0	17	8.2

Source: Bank of Sudan Reports.

With regard to the structure of these resources (deposits in particular), it is clear that the majority of IBs deposits are in current account form (see Chapter VII, Table 7.16). Although the ratio of investment deposits to total deposits declined, it still remains a fact that IBs have fairly adequate financial resources for sponsoring investment projects.

Therefore, regarding closely the liability side of IBs, they are, as mentioned repeatedly, capable of financing investment projects of a long-term nature. This implies that IBs are financially able to invest in productive projects, and that there are no problems in this respect if other obstacles are removed.

Thus, this factor as a determinant of the contribution to finance development was not an obstacle for IBs. Managers of IBs themselves indicated that no IB which wishes to invest in productive projects is faced with illiquidity problems.

8.5.2 Strength and character of demand:

Banking systems are not 'neutral' with respect to economic development. Where they exist, they do so because there is a demand for their services, and such demand is usually evidence of a growing, developing economy. Can the weak contribution of the banking system in general, and the IBs in particular, be attributed to the nature of the demand for medium-and-long-term investment projects?

In order to examine the strength and nature of demand, investors of IBs were asked through a questionnaire to indicate the factors that affect their decision to take loans from IBs, especially the demand for medium-and-long-term credits, and to comment on their experience with IBs. The characteristics of the sample and the procedure followed in selecting the sample and administering the questionnaire are discussed below.

8.5.2.1 Investors: sampling and characteristics

The same procedure adopted in the case of depositors was followed in the case of the investors' sample. That is to say, the same of questionnaire structure, and methods of pre-testing was adopted here, (see Chapter VII, sections 7.5.1.1 and 7.5.1.2).

(i) Total and sampled population:

The target population consists in the IBs' investors. As in the case of depositors, the main drawback was the inability of transport to get through to rural and remote areas where bank branches are found. The total population of investors was sampled so that the 'sampled population' comprises IBs investors in the capital, Khartoum.

(ii) The sample:³⁴

The sample size was calculated as follows:

$$SE = \sqrt{\frac{\pi(1-\pi)}{n}} \text{ and therefore } n = \frac{\pi(1-\pi)}{(SE)^2}$$

³⁴ See C. A. Moses, (1965), *Survey Methods in Social Investigation*, London, Heinemann Educational Books, p.116.

where

SE = the margin of sampling error that is tolerated

π = the proportion with the particular attribute in the population. SE can be estimated using a pilot survey.

n = sample size.

IBs investors in urban areas represent the particular attribute in the population which was the basis for calculating the sample size. The author was unable to obtain certain figures concerning the number of investors with IBs or their distribution between rural and urban areas. However, because of the relatively heavy concentration of banking activity in urban areas, the 'sampled population' was expected to be large, as a proportion of 'total population' not less than 80%; therefore the proportion was (using a pilot survey) around 85%.

Again, the margin of sampling error tolerated was 3%. Accordingly, the sample size was calculated as

$$n = \frac{0.85(1-0.85)}{(0.03)^2} \approx 140$$

The method used in selecting the sample was *simple random sampling*, and the random sampling was *stratified* so that our sample is a *stratified random sample*. However, the same process of stratification and choice of the sample that was used for the depositors was also adopted here.

(iii) Administration of the questionnaire and investors classes:

The total number of questionnaire forms distributed was 150. It was difficult to meet investors in person since their addresses are not clear and at the same time many were reluctant to respond. Of the 150 investors chosen, only 55 filled in the forms and returned them.

Investors were asked to indicate the size of investment operations they actually undertook. Branch managers were consulted to determine classes of the investment operations according to size. Operations were classified as follow:

LS 50000- 100000 — small size operations

LS 201000- 400000 — medium-size operations

Above LS 400000 — large-size investment operations.

According to this classification, investors were found to be distributed as follows

Table 8.7: Investors Classes

Range (LS 000) & classification	Number	Percent
50-100} small-size	36	65
101-200} small-size	7	13
201-300} medium-size	5	9
301-400} medium- size	3	5
401-500} large-size	2	4
500-million} large-size	2	4
Total	55	100

Source: Investors Survey, 1989

8.5.2.2 Survey results: analysis and discussion

- **Frequency distribution analysis**

The strength and nature of demand, as a determinant of the role of IBs in financing economic development, could be interpreted by (1) examining investors' attitudes towards investment conditions specified for obtaining credit, thus assessing the strength of demand, and (2) by seeing whether investors are ready to take credit for productive investment projects, thus learning something about the nature of demand.

It is worth mentioning that the group of investors who filled in the questionnaire forms indicated that they already enjoy business relations with conventional banks. Thus, of the new depositors attracted to the IBs, (see Chapter VII, section 7.5.2.1), the majority (51%) are investors who have already had dealings with banks.

(A) Strength of demand

(i) Factors affecting investors decision:

As a rule, there are certain conditions that attract customers (investors) to a bank, be it Islāmic or conventional.

To ascertain the most important factors that affect an investor's decision to have credit, the following conditions were listed in the questionnaire and investors were asked to show which of these, in order of importance, affect their decision whether to obtain credit:

- The repayment period
- The period of grace
- Profit margins taken by the bank
- Type of guarantee required by the bank
- Freedom to use the credit fund.³⁵

The customers' responses were as follows:

Table 8.8: Investors Responses on Credit Conditions

	Frequency	Valid percent	Rank
Repayment period	53	27.7	I
Grace period	40	21	II
Profit margin	40	21	II
Type of guarantee	39	20	III
Freedom to use credit	19	10.3	IV
Total	191	100	-

* Total is not 55 because a customer indicated more than one condition.

Source: Investors Syrvey, 1989.

³⁵ If a customer deals with a conventional bank, he has more freedom to use the loan fund; an Islāmic bank does not allow customers to use the credit fund except for its purposes. This procedure sometimes discourages investors to deal with IBs.

It is clear that the most important factor affecting investors' decisions is the repayment period, (27.7 %); this is followed by the grace period and profit margins taken on loans (21 % for each). The type of guarantee is only slightly less important for customers (20 %). Few customers mentioned the importance of freedom to use a credit fund. Thus one might conclude that investors are assumed to increase their demand if, firstly, the repayment period is long enough; secondly, if the grace period is long enough and profit margins on loans are reasonably low; and thirdly, if the type of guarantee required by the bank is easy to provide.

(ii) Customers' experience with IBs:

Given that the customers indicated the importance of the credit conditions as shown above, what then is their experience with IBs?

Customers were asked to show the length of repayment period for the investment operations they undertook with IBs. Period lengths for repayment were specified and customers gave the responses shown in Table 8.9.

Table 8.9: Repayment & Grace Periods of Investment Operations

Period length (months)	Frequency*	Valid percent	Frequency*	Valid percent
1-2	5	4.8	45	43.3
3-6	80	76.9	52	50
7-9	8	7.7	4	3.8
10-12	4	3.8	3	2.9
above 12	7	6.7	-	-
Total	104†	100	104	100

* Investment operations with regard to repayment period

★ Investment operations with regard to grace period

† The total is 104 and not 55 since some customers deal with more than one bank and were asked to show all investment operations they had.

Source: Investors Survey, 1989.

The experience of customers with IBs shows that for all IBs the repayment period is too short, i.e. between one and six months. Thus nearly 82% of the investment operations undertaken by customers have repayment periods of six

months at the most. Investment operations that had fairly long periods (between ten and twelve months or more) were only 10%.

On the other hand, the grace period of 93% of investment operations did not exceed six months. Only 3% of investment operations had grace period of between ten and twelve months.

The point here is that although customers ranked the repayment and grace periods as the most important factors affecting their decision to apply for credit, their experience with IBs shows that the repayment and grace periods were short. This may be one of the reasons why demand for financing medium-and-long-term investments was low.

However, profit margins imposed by banks on credit was, according to the customers, equally important for them in their decision to obtain finance. Customers were asked to show profit margins on operations they had with IBs; the results obtained are shown on Table 8.10.

Table 8.10: Profit Margins on Investment Operations

Profit margins (%)	Frequency	Valid percent
0-5	20	19.2
6-10	65	62.5
11-15	7	6.7
16-20	3	2.9
21-25	7	6.7
25	2	1.9
Total	104	100

Source: Investors Survey, 1989.

It seems from the above figures that the profit margins were, in general, not too high. Almost 82% of investment operations had profit margins ranging between five and ten percent. In fact, it cannot be said that the profit margins of IBs were low, since the margins depend on the liquidation period of investment operations. Almost all customers agreed that the profit margins of IBs are high, and thus it

is possible to attribute low demand by customers to the profit margins imposed by IBs on investments in general and on medium-and-long-term investments in particular.

The type of guarantee also affects customer demand. Customers were asked to indicate, according to their experience with IBs, whether they were able to provide the guarantees required by IBs. 71 out of 104 investment operations, i.e. 68.2%, were obtained on *difficult* guarantee; 32 (30.8%) were extended on *easy* guarantees and 1% of investment operations were funded without guarantees being required.

From the above argument the following can be deducted:

(a) Customers give priority, in order of importance, to the repayment and grace periods; profit margins; and to the type of guarantee required by a bank.

(b) Customers' experience with IBs shows that the repayment and grace periods were short, so that they sometimes refrained from demanding credit for medium-and-long-term investments.

(c) Customers acknowledged the considerable influence of profit margins on their decision to ask for credit. Again, the profit margins imposed by IBs on investment operations that customers had were high, so that investors were discouraged from having more credits, especially for medium-and-long-term investments.

(d) The type of guarantee required by a bank is not less important for customers. In this respect investors indicated that the type of guarantee required by IBs is difficult one. If demand was constrained by the short repayment and grace periods and by high profit margins, they were also hindered by the type of guarantee required by IBs.

(e) it is clear from the above analysis that demand is in general low since customers were constrained by the conditions specified by IBs for granting credits. If IBs wish to encourage customers to increase demand, these conditions should be relaxed so that customers would be able to fulfil them.

Hence, the strength of demand is likely to be weak. What then is the nature of demand? In order to examine this, it is important to see whether investors are willing to ask for medium-and-long-term investments.

(B) Character of demand:

Firstly, investors were asked to show the distribution of their investment operations between the following sectors: trade, agriculture, industry and transport. An investment in any of the sectors except trade is regarded as productive investment. The following responses were given by customers:

Table 8.11: Sectoral Distribution of Customers Demand

	Frequency	Valid percent
Trade	61	58.7
Agriculture	10	9.6
Industry	25	25
Transport	8	7.7
Total	104	100

Source: Investors Survey, 1989.

Trade constituted 58.7% of the total of investment operations undertaken. Customers would like to take credit for trade rather than for productive investments.

In order to provide further evidence for the general tendency to avoid productive investments, customers were asked to state whether they brought feasibility studies for banks to finance medium-and-long-term investments. Only 28 (26.9%) replied that they had applied for credit in productive sectors, while the majority (73.1%) answered that they had not. Among those who applied for productive credit, 18% wanted the credit to undertake agricultural projects, 50% planned to finance industrial enterprises and 32% wanted credit for transport.

Third, customers were found to prefer *murābaha* to *mushāraka*. 70 customers (67.3%) said that they used *murābaha* while 34 (32.7%) used *mushāraka*. However, it is known that *murābaha* is in most aspects a trade finance and therefore customers use it more frequently than *mushāraka*.

The preference for *murābaha* over *mushāraka* may be attributed to the fact that banks impose a certain mode of finance on customers. But the responses of investors reveal that banks do not force them to be given credits according to a

particular mode. 77 customers (74%) said that the IBs they dealt with did not impose on them a specific mode of finance. In addition, the customers said that they preferred *murābaha* since the procedure is an easy one and the bank does not share profit with them.

Therefore it is the customers who determine to a great extent the nature of demand by preferring trade finance rather than productive loans.

The question now is, what were the causes of the customers' reluctance to apply for productive loans and their preference for trade finance? The following causes were specified and listed, and investors were asked to say whether these affect their choice between trade finance and productive loans: (1) high and (mostly) certain profit on trade finance; (2) low risk of trade finance; and (3) inadequacy of capital to undertake productive investment. Customers gave the following responses:

Table 8.12: Customers Preference for Trade Finance

	frequency	Valid percent	Rank
Low risk	39	35	I
Inadequacy of capital	37	33	II
High profit	35	32	III
Total	111	100	-

Source: Investors Survey, 1989.

For customers, low risk is a factor which determines the choice between trade finance and productive loans. This finding implies that investors are not prepared to take risks; therefore, they gave high priority to the low risk of trade.

Another important factor is the inadequacy of capital required for medium-and-long-term investments. Thus, apart from the fact that customers are not prepared to take the risks involved in medium-and-long-term investments, they also lack the capital to do so.

To conclude: (i) demand for medium-and-long-term investments is basically demand for trade finance; (ii) the two most important reasons for this tendency

were found to be the unwillingness of customers to take risks and the lack of capital to undertake this kind of productive investment.

- **Crosstabulation analysis**

(A) Strength of demand

It was mentioned earlier that the repayment period, the grace period, the profit margins and the type of guarantee required all affected customer demand. In particular these factors affected investors from low-income groups. This finding is revealed when these factors are crosstabulated by the size of investment operations customers had with IBs. The SPSSX programme was used and the results obtained are shown on crosstabulation tables (A) and (B).

Crosstabulation (A): Repayment & grace periods by size of investment operations

	50-100*	201-300	401-500
Repayment period: important	8	2	1
Grace period: important	5	2	1

* Investment operations in (LS 000)

Source: Investors Survey, 1989.

Crosstabulation (B): Profit margins & type of guarantee by size of investment operations

	50-100	201-300	401-500
Profit margins: important	5	1	1
Type of guarantee: important	7	2	1

Source: Investors Survey, 1989.

It appears that customers from low-income groups put great importance on the impact of these four factors on their decision to apply for credit from banks. The crosstabulation analysis confirms the frequency distribution analysis that customers, especially those from low-income groups, were constrained by the conditions specified for investment; consequently demand is low.

(B) Character of demand:

The frequency distribution analysis on character of demand, as shown above, shows that (i) customers were found to be avoiding risks involved in productive investments and (ii) that they lacked adequate capital to undertake these types of medium-and-long-term investment projects. Crosstabulation analysis provides more evidence for these findings.

Firstly, regarding the aversion to risks, it was stated above that one piece of evidence for this is the high priority given by customers to the low risk as a factor determining the choice of trade finance. Further evidence is that customers prefer *murābaha* (as a trade finance) rather than *mushāraka* as participation financing.

However, when the mode of finance as preferred by customers was crosstabulated by the low risk element as a reason for choosing trade finance, the SPSSX programme came up with the following results:

Crosstabulation (C): Type of mode by low- risk element

	'yes' risk is reason to prefer trade finance	
<i>murābaha</i>	9	64.3%
<i>mushāraka</i>	5	35.7%

Source: Investors Survey, 1989.

This finding proves that customers are unwilling to take the risk of having credits for medium-and-long-term investments, and this is one of the reasons that might explain why the demand for such investments is low.

The lack of adequate capital was found to be one of the causes of low demand for productive investments. Thus the nature of demand is such that customers

prefer trade finance to productive loans. Crosstabulation provides evidence for this argument. When the 'size of investment operations' was crosstabulated by the 'inadequacy of capital as a reason for preferring trade finance' the following findings were obtained:

Crosstabulation (D): Size of investment operations by inadequacy of capital

	50-100	101-200	201-300	301-400	401-500	500-million
'yes' inadequacy is	24	6	4	1	2	2
a reason	(6.5)*	(6.5)	(6.5)	(6.5)	(6.5)	(6.5)

* Expected frequencies.
 Chi-square = 58.39; df = 6-1 = 5

Source: Investors Survey, 1989.

Put in statistical form, the argument is as follows:

The null hypothesis is that there is an equal impact for the indequacy of capital (as a reason for the avoidance of productive investments) on the classes of customers, so that both those who undertake small-size and those who undertake large-size investment operations avoid medium-and-long-term investments due to lack of capital.

The research hypothesis is that the impact of the inadequacy of capital is greater on the group of small-size investors; therefore they are more likely to avoid medium-and-long-term investments.

Applying the one-variable use of chi-square technique, χ^2 is 58.39.

Comparing 58.39 (the calculated value) to the critical value(s):

$$\chi^2 = 58.39 > 11.07 \text{ at } 0.05 \text{ probability level (df = 5)}$$

$$\chi^2 = 58.39 > 15.08 \text{ at } 0.01 \text{ probability level (df = 5)}$$

$$\chi^2 = 58.39 > 20.517 \text{ at } 0.001 \text{ probability level (df = 5)}$$

Since the calculated value is higher than the critical values at all levels, the decision to be made is to reject the null hypothesis and accept the research hypothesis. The conclusion is that the impact of inadequacy of capital is not equal for all customers. It is greater for low-income customers and therefore they are more likely to avoid productive investments and choose trade finance.

- Summary:

For investors of IBs, the following elements, in order of their importance to customers, affect their decision to demand credit: (i) repayment period, (ii) grace period, (iii) profit margins and (iv) the type of guarantee.

IBs specified these elements as conditions for obtaining credit. But the field-work findings reveal that the repayment and grace periods are too short and that profit margins are high, which discouraged customers from applying for credit. Thus demand was affected especially demand for medium-and-long-term investments. In other words, demand is weak.

The findings of the survey show that customers refrained from applying for credits for productive investments and tended instead to go for trade finance.

There are two reasons for customers' preference for trade finance rather than productive loans: (a) customers are not ready to take risk and (b) they lack adequate capital. Therefore the attitude of customers in this regard is characterised by low demand for medium-and-long-term investments and high demand for short-term or trade finance.

Thus, part of the insignificant contribution to medium-and-long-term finance by IBs might be accounted for by the inability of customers to fulfil some conditions specified by IBs for investments, and their tendency to avoid risks and prefer trade finance. Moreover, most customers (investors) of IBs would not like the bank to share their profits, especially the more successful entrepreneurs. Thus, IBs managers showed that the demand by this group of entrepreneurs for participation financing is low. Investors prefer participation financing only when the risk is high. Managers also indicated that the traditional form of Islāmic partnership is not attractive to some customers, since they do not like to disclose their secrets,

and this form of partnership gives the bank the right to interfere in the partners' affairs.

8.5.3 Management attitude

Management attitude is regarded as the second perceived determinant of the contribution of IBs to economic development. In this regard, how do managers behave?

Firstly, IBs managers said that there is an insignificant contribution to financing seed capital since it is highly risky, and at the same time there are no demands for such investments except in rare cases. They also said that financing is concentrated on domestic and international trade and on some manufacturing projects in major cities, while no such financing is available for small farmers and craftsmen outside large cities. The cause, they said, is the weak infrastructure and the inability of management to control the small projects in rural areas. In fact, there have been some successful attempts by FIBS and the Sudanese Islāmic Bank to fund small handicrafts and farmers.

Secondly, collateral is one of the determinants of demand for medium-and-long-term investments. For managers of IBs collateral is very important, and some investment operations could not be financed unless the customer (investor) provides the bank with adequate guarantees. Because most investors are unable to fulfil this condition, the banks are most likely to refrain from funding the projects³⁶

Thirdly, the personal qualities of the clients affect the attitude of the bank towards accepting or rejecting an application. All managers of IBs agreed on the importance of clients in granting credits. This finding implies that in their decisions to give credits, IBs depend predominantly on qualified and sound customers. This might be necessitated by the nature of the Islāmic mode of finance of *mushāraka* and *muḍāraba* the execution of which depends heavily on the honesty and trustfulness of customers (partners). This requirement also restricts the demand for credit.

³⁶ Usually, IBs require a guarantee not to cover losses, if incurred, but to make sure that there is no kind of negligence or dishonesty on the part of the clients.

Fourthly, all managers of IBs, except one, indicated that the low demand for productive projects by investors had a considerable passive impact on their decision to finance these types of investments. It is true that the demand for productive investments originated partially from the principal weaknesses of the Sudanese economy which were identified as the shortage of human capital at the managerial or entrepreneurial level as well as throughout the labour force. The IBs and the banking system in general are almost powerless to solve these problems. But the fact remains the case that IBs should shoulder part of the responsibility of financing productive investments.

Thus the demand for medium-and-long-term investment has a great impact on the contribution of IBs to the funding of these productive activities. IBs are financially capable of funding medium-and-long-term investments; no IB is now facing a problem of short-term maturity of deposits when investing in productive projects. IBs have been successful in mobilising a high proportion of savings, and their financial position is strong since they have multiplied their fixed assets and built considerable reserves. These financial potentialities enable IBs to absorb disturbances or uncertainties inherent in financing development projects.

Moreover, if demand is low, IBs should be 'supply leading' rather than 'demand following'. They do not have to concentrate on short-term self-liquidating commercial loans; rather, they should establish close ties with productive investors, especially those in rural areas, and provide funds for fixed investments as well as for working capital.

This 'supply-leading' policy is quite important, not only because demand for corporate financing is low, but also because IBs are able to finance this type of investment. They need only to maintain sound banking assets. The sound banking asset is one which is 'self-liquidating'. A 'self-liquidating' credit is one the debtor is thought sure to be able to repay, and this depends on the return which the operation realises. In short, to prevent difficult liquidation, IBs have to maintain the total volume of their lending. Only by maintaining their assets can IBs maintain the 'self-liquidating' character of a substantial number of them.

Fifthly, although managers indicated that the demand is low, they compete with each other for the same group of investors. To solve the problem of low de-

mand, and instead of competing with each other, IBs could follow a comprehensive financial approach, i.e. specific types of financial institutions for specific functions. IBs should differentiate between commercial capital which is liquid and has a high turn-over, and agricultural and industrial capital which is of a fixed nature. Since the functions of these different kinds of capital are different, so too should be the institutional sources of their financing and the kind of collateral used.

Sixthly, IBs lack skilled staff to undertake feasibility studies for medium-and-long-term projects. Traditionally, bankers, as providers of short-term capital for traders, have been accustomed to consider primarily a borrower's honesty and good faith and his balance-sheet position. If the honest borrower has a reasonably liquid position, he can be counted upon to repay a temporary advance. It is not enough for IBs to concentrate solely on the trustfulness of the clients if they are to provide credits for long-term investments. A provider of long-term capital is concerned not so much with the balance-sheet position as with the long-term earning capacity of the borrower. Assessment of the earning capacity is a very different task from assessment of the current balance-sheet position. It calls for a long view of markets, both for raw materials and for products, and of technical possibilities of labour supplies.

Assessment of these factors can be undertaken reasonably by a larger group of specialists. Therefore, IBs need feasibility study units, with experts specialising in one, or more industries. Because of the lack of feasibility studies units, productive financing given by IBs was for working capital. The financing was provided on the basis not of participation, but of *murābaha*.

Seventhly, IBs managers showed that they use, in one way or another, deposits of branches in rural areas when funding investment operations in urban areas. These operations, apart from being in urban areas and at the expense of rural areas, were in the form of trade finance. This attitude implies that IBs do not initiate or develop investment opportunities in rural areas; in actual fact they have deprived rural areas of their own resources. This tendency should surely affect demand in general and especially the demand for productive investments.

Eighthly, IBs are now investing through customers and subsidiary companies, but no IB is involved in direct investment. Given that demand for medium-and-

long-term investments is weak, and IBs depend on investment through customers, the low contribution to financing productive investments is to be expected.

IBs can initiate their own productive investment projects and involve themselves in direct investments. Alternatively they can encourage investors who are risk-takers but who lack adequate capital. The experience of direct investments by IBs is still limited, especially in agricultural and industrial sectors. FIBs has attempted to invest in rain-fed mechanised agriculture on large scale.

Ninthly, Sudan is a poor country in terms of per capita income and output, but it has potential for every productive investment since it is endowed with numerous and immense natural resources. One of the difficult problems of development is the inadequacy of capital. Even so, IBs are involved in investing part of their capital abroad and are considering a more concentrated international approach to business, (see the summary above). This sort of management attitude has deprived the Sudanese economy of the resources and investible capital that it so desperately needs.

Finally, profitability is affecting the decision of managers in allocating funds for both short-and-long-term investments. IBs managers put great importance on the profitability of the projects they undertake. This, of course, affects their attitude towards productive investments that are of low, or uncertain, return.

- Summary:

One could conclude that the attitude of IBs managers is not conducive to medium-and-long-term investments. The lack of expert staff; the concentration on investors in urban areas; the great emphasis on collateral without differentiating between the nature of the proposed projects; the shifting of resources from rural to urban areas; the emphasis on the profitability of a project; and the moves towards a more international approach for business all of these are factors which influence IBs' managers to sponsor productive investments. Therefore the management attitude as a determinant of the role of IBs in medium-and-long-term investments has affected that contribution negatively. The insignificant contribution can thus be attributed partly to the behaviour of managers of IBs.

8.5.4 An Attitude of authorities:

Chapter VI discussed the monetary policies followed by the Bank of Sudan. Chapter VII discussed the credit policies which affect the liabilities and liquidities of commercial banks in general. It showed the implication of this for IBs and their market share. The question now concerns the nature of credit policies adopted by monetary authorities to regulate and control the asset side of all banks, and in particular IBs.

If a banking system is to be effective in contributing to productive capital formation, the government must assure minimal financial and political order and refrain from the kind of random interference that increases uncertainty for large-scale investment planning. In order to examine the attitude of authorities, credit policies are explored below, and the credit policy of 1986 is taken as an example.

8.5.4.1 Credit policies: description , critique and implications

In general, a credit policy is a number of measures and directives issued by the Central Bank to commercial banks to control money supply and arrange banks' lending to the private sector so that it might be used in productive economic sectors. These measures and directives are concerned primarily with control and rationalisation of banking credit and to a lesser extent with the control of commercial banks' liquidity. The first part of these measures were listed and discussed in Chapter VII. What now follows is listing and elaboration of the second part.

A credit policy should be developed in the context of monetary control. Monetary control implies the use of instruments such as the discount rate, variation in the legal reserves ratio, open market operations and liquidity ratios. In reality credit policy is not a substitute for monetary control. A credit policy is designed to direct funds to productive activities, but the policy is useless unless the overall expansion of credit is kept in check to prevent inflation. Credit policy is basically allocative. Monetary control is designed to determine the levels of economic activities. But there is no evidence to suggest that the Central Bank has depended increasingly on the credit policy because it is flexible and easy. It is, however, a mistake to believe that the Central Bank could achieve through it the objectives of monetary policy as quickly as possible.

In fact, the credit policy is important in this respect because of the impossibility of making use of the open market operations, the failure of discount rate policies, the manipulation of interest rate due to the absence of money and capital market, the public's aversion to dealing with the interest rate, and the limitations inherent within the banking sector.

(I) Credit policy (1986):

The credit policy aims in general at reducing inflation and increasing growth rates by rationalising consumption and making optimum use of the resources available.

With regard to control of lending, the policy aims at:

1. Promotion and encouragement of the export sector by allocating not less than 30% of each bank's ceiling to finance exports with easy conditions.
2. Increasing the production and utilisation of excess capacities in local industries by allocating not less than 25% of each bank's lending ceiling with easy conditions to give incentives to producers.
3. Prohibiting financing and storage of some basic crops except for export or to provide local industry with its needs.
4. Restricting any extension of finance to the import of non-essential commodities.
5. Confining the financing of local trade activity to the public sector and joint banks only.
6. Directing finance to productive activities by granting medium-and-long-term loans and participation in the capital of productive projects, so that loans to this will not be less than 35% of the ceiling given to joint and foreign banks, and be about 20% of the public sector banks' ceiling.

(II) Critique:

The first thing that may be noticed about this particular credit policy is its inability to bring down inflation and increase the growth rate. The inflation rate

is almost continuously on the rise. The economic growth rate of the economy has been negative. The main cause of this is basically structural. Therefore, credit policies are able to play only an insignificant role, by solving some of the financing problems or affecting the total demand.

Secondly, in the case of the export sector, those who benefit are the exporters, not the producers, of the exportable commodities. Exchange rates are low and discouraging for producers especially with the high costs of production.

Thirdly, for medium-and-long-term participation in the capital of productive projects, the policy differentiates between the government and the private banks, so that the former would extend not more than 20% of their ceiling to the productive projects, while the latter would extend not less than 35% of theirs. Although this redirection of financing to the productive projects is a forward step, it is too much for private banks with their limited ceilings. It might be appropriate to order all banks to allocate, for instance, 10% of their credit ceilings, and to increase this amount gradually. In this way commercial banks would be in a better position to finance the productive sectors which are of a long-term nature and at the same time remain involved in profit-generating activities of a short-term nature.

Fourthly, the policy no longer suits an increasing volume of private sector savings in the form of deposits that require profitable outlets; that is to say, the policy is inappropriate as regards the increasing need of the Sudanese economy for investment in different economic fields and the role of commercial banks in extending development financing. Although the policy has attempted to attract commercial banks to invest in productive sectors, which is desirable and important, it has neglected the need of commercial banks to generate adequate profits, at least to reward those who keep deposits and hold shares with commercial banks. No bank applies this policy without affecting its return negatively, (see Chapter VII, section 7.7)

Fifthly, the number of banks and their branches has increased tremendously. The credit ceilings policy does not allow branches in remote areas to meet the demands of customers there for loans.

Prices are increasing continuously because of the deterioration in the value of

the Sudanese pound and the rising costs of production. Therefore the increase in banks' ceilings is almost absorbed by these prices' increases and in real terms there is no increase in the ceilings assigned to banks.

Sixthly, an imposition of ceilings on private commercial banks is not expected to reduce money supply and inflation, one of the main causes of which is the deficit financing of the central government and public corporations. Commercial banks depend on private savings mobilisation to provide funds for investment; whatever the volume of their credit in the Sudan, they cannot affect the level of prices in the same way deficit financing of the government can.

The credit ceilings policy has resulted in a large proportion of private savings standing idle. These idle financial resources are indicated by the high rates of cash reserves of commercial banks with the Central Bank. As a proportion of assets, commercial banks' reserves with the Bank of Sudan increased from 13.6% in 1983 to 21.53% in 1984 and 34.4% in 1986, (Ministry of Finance, Economic Survey, 1986/87)

In 1987, the Bank of Sudan adjusted the credit policy of 1986 which had already specified certain proportions of the credit ceilings to be allocated to productive sectors. The 1987 policy was considered more flexible in this regard. It required financing of sectors which are of great importance and priority to be not less than 80% of each bank's ceiling. The sectors are: export; working capital for agriculture; small-scale crafts; and medium-and-long-term development financing.

In justifying this policy, the Central Bank mentioned that it aimed at directing banking credits to fund productive sectors and the related activities to enable banks to respond flexibly according to the needs of the leading economic sectors.

As for medium-and-long-term financing, the policy eliminated the priority that was first given to such types of financing. The defect of this policy is that banks are able to avoid financing medium-and-long-term financing without contravening the policy itself.

As early as 1988, the 1987 credit policy was revised but there were no big changes except that the new policy added that: (1) what is meant by medium-and-long-term financing is the loans with a repayment period of more than one year and

which are granted for financing fixed capital in agriculture and industry, loans for crop transportation, financing of small crafts firms; and participation in companies' capital; (2) in choosing productive investment projects and financing small crafts units, banks should give priority to less developed regions of the country.

(III) Implications:

The implications of this kind of policy are quite obvious:

The stringent credit policies forced banks (and IBs in particular) to stop receiving investment deposits since IBs are unable to place these funds in profit-generating outlets (see Chapter VII, section 7.7). They were unable to do so because IBs have multiplied their capital, reserves and deposits but were given limited credit ceilings. These credit ceilings were too narrow given the financial resources available.

If IBs as profit-makers do not have the chance to invest all the resources available to them, they are more likely to give priority to the allocation of shareholders' funds rather than those of depositors. Thus IBs stopped receiving new investment deposits. But the unabsorbed portion of private savings will either find their way to the informal money market or will be used in residential investments. However, both types of activities are marginal and unproductive.

The Central Bank needs to design a credit policy that combines the developmental efforts of all commercial banks with a sufficient overall profitability of the total funds. Nowadays reserves of IBs have been accumulated as idle reserves with the Central Bank. For instance, Taḍāmon Islāmic Bank's reserves ratios with the Central Bank increased from 16.6% in 1983 (the year of a start) to 44.6% in 1984, 50.8% in 1985 and 56.5% in 1986, (*Al Muq̄tasid*, Taḍāmon Islāmic Bank Magazine, January, 1987, p. 57). These funds could be freed to be placed in different projects. If the Central Bank is to resort to a credit ceilings policy, it could link these ceilings for every bank with its resources from capital and deposits, so that the ceiling can be increased or decreased according to the movements of the financial resources of any bank.

● Summary:

The conclusion is that so far as the effect of public policies on the role of banks in economic development is concerned, one could say that policies have affected this role negatively. The government's policies have been consistently protectionist, and therefore bankers in particular, and industrial entrepreneurs in general, have adopted conservative behaviour.

Public policies hinder the banking system by increasing the taxation of profits. Moreover, the continuous deficits of the government's budget have affected both bank behaviour and capital formation.

Of course, it is not only the attitude of authorities which has affected the contribution of all banks to the financing of productive projects; structural problems of the Sudanese economy have also hampered the role of banks in this regard. To all managers of IBs, structural bottlenecks in the economy are hindering investments in productive projects to a great extent. For managers, uncertainties surrounding productive investments are high, especially given the nature of the Sudanese economy.

The new regime (in power since June 1989) held an *Economic Conference for National Salvation* in October 1989. At this conference it was decided to change the laws for encouraging investments in the Sudan. The characteristic features of the new law are:

(i) No differentiation between foreign and local investors, or differentiation between investment projects.

(ii) Encouragement for investments in agriculture, industry, animal production, the service sector and other productive activities.

(iii) Concentration will be on (i) investment projects which have more potential for increasing national income, expanding the economic base, diversifying economic activities, increasing the value added, using the local resources and enhancing the export potentiality of the economy; and (ii) those projects in the less developed regions of the country.

The new law introduced more concessions, tax and customs duty exemptions, especially duties on the importation of inputs for investment projects.

Of vital importance is the recommendation of the conference with regard to financial institutions. The conference asked for : (a) a study to establish an investment-guarantee corporation, subsidising the three specialised banks and the Sudanese Development Corporation in order that they might play an effective role in investment; (b) encouragement of investment and finance companies and investment banks; (c) a study of the possibility of setting up a market for financial securities; (d) and finally, and this is crucial, a study of the possibility of releasing the domination (monopoly) by the public sector of some investment sectors, to encourage competition from private sector.

The government also held a conference for Sudanese nationals working abroad (SNWA) in August 1989, ratifying its proceedings in October 1989. Recommendations of the conference were intended to encourage and improve the investment environment. They include:

- Introducing of appropriate amendments to laws regarding investments, taxes and other economic measures.
- Continuation of these investment policies so that investors would not be hesitant and reluctant due to changes in policies.
- Reducing profit margins of the banking system to reduce costs and inflation rates.
- Encouraging the more attractive modes of finance of *muḍāraba*, *istizra'* and *istisna'*. These are the Islāmic modes of finance of equity capital, participation in agricultural credit and industrial credit respectively.
- Most important of all is the amendment of the credit policy of the Central Bank so that the credit ceilings granted to banks would be increased to allow more investment opportunities for the SNWA to place their savings in the productive units.
- One more recommendation emphasizes on planning and preparation of land in different regions to establish handi-crafts and small-scale industry units to be funded by the SNWA.

All of these recommendations reveal a big change in the government's attitude towards development financiers in general and banks in particular.

These measures notwithstanding, obstacles in the path of Sudanese economic development are numerous. These include:

- (1) Primitive techniques employed in industry and especially in agriculture
- (2) Widespread illiteracy and ignorance. These are handicaps that cannot be dealt with through conscious policy, at least in the short-run, even if the policy makers are inclined to do so.
- (3) The economy is facing huge public debt; on top of this, the government is quite unable to balance current receipts and expenditures, and as a result the nominal debt has quadrupled over the years. The civil war has been the most disastrous event in this unhappy series of setbacks.
- (4) Political instability has upset responsible measures intended to secure financial reform.
- (5) Given the financial instability of the government, private domestic capital accumulation on any significant scale is virtually impossible. The government sometimes follows discriminatory policies, which account for the disappointing contribution of the banking system to economic development. There are facilities given by the Central Bank to government banks rather than other commercial banks including IBs.

To conclude, the role of IBs in financing medium-and-long-term projects has still been limited. One of the main reasons for this is the public policy towards banking system in general and IBs in particular. Government policies should encourage banks to be more concerned about long-term investments. There should be long-term policies to solve the problems of the Sudanese economy in the first place, and to reallocate banks' funds towards investment spending instead of consumption spending.

8.5.5 The character of Islāmic modes of finance:

IBs operate primarily three forms – *mushāraka*, *mudāraba* and *murabaha* each

with different informational needs and operational problems. This may affect the demand (investors' attitude) and supply (management attitude) of medium-and-long-term investments as follows:

(a) *Mushāraka*:

Certain information requirements are necessary to formulate and implement a *mushāraka* deal. In undertaking a *mushāraka* contract, IBs need information on (1) a commodity or a factory, (2) marketing information and (3) personal information about the client.

This list is in the perceived order of priority for the success of *mushāraka*. The problem facing IBs managers is the external information. The managers argue that information about the market and commodities are not very reliable because the economic environment is changing rapidly. Under these conditions IBs are unable to apply *mushāraka*.

Apart from information, there are other problems in following *mushāraka*:

(i) Better entrepreneurs are unwilling to contemplate participation financing. Managers of IBs indicated that the demand by this group of entrepreneurs for participation financing is low. Investors prefer *mushāraka* only when the risk is high.

(ii) The traditional form of Islāmic partnership is not attractive to customers, since they do not like to disclose their business affairs, and this form of partnership gives the bank the right to interfere in the partner's affairs.

(iii) In most cases the partner's share in the capital of the venture is in the form of machinery, buildings, etc. The problem facing IBs is the valuation of such assets. The partner always looks for a high value in order to claim a high share of profits. There are no professional valuers in the Sudan and FIBS deals with the matter through negotiation and arbitration.

(iv) In managing any *mushāraka* wherein fixed assets are provided by the partner, problems arise with regard to the treatment of depreciation. Depreciation as an expense item has created some problems and the *Shari'a* Supervisory Boards

(SSBs) of all IBs disapprove of this concept as it is elaborated in the current economic literature because it is based on inaccurate estimations. This could be unfair for either of the partners, and therefore the SSBs of IBs reject it. Moreover, the cost of depreciation is disapproved by the *shari'a* because it is a proxy, not a value.

(v) Valuation of management remuneration; in running a *mushāraka*, the arrangement of the partnership is left mainly to the partner. For his pain he gets a percentage of the realised profits. The problem is how to put a value on this effort and how to relate the percentage to the effort objectively.

(b) *Muḍāraba*:

The nature of this mode of finance may restrict the supply for medium-and-long-term financing since it depends predominantly on a customer. Therefore emphasis lies on the collection of information on a client. Before being given finance, clients are investigated with respect to their experience and honesty. Managers have indicated that the personal qualities of a customer have in many cases restricted granting credits for productive investments.

If *muḍāraba* credit is to work efficiently, IBs need to obtain full information about their clients' experience and trustfulness. However, in the absence of a proper accounting system and statistics on clients, information is difficult to obtain. Because of this problem, there is a tendency among managers to concentrate on customers whom they know personally.

In practice, IBs have devised strict rules and regulations for the initial selection of customers, although this does not guarantee that customers will declare their actual profits on the venture. In the Sudan the law does not require enterprises to have proper books and records except those registered as limited companies. Banks simply have to trust customers on what they reveal as profits. It is often difficult or impossible for the bank to determine the exact figure because records may be incomplete or non-existent. The problem is a formidable one because by increasing costs it encroaches on the bank's revenues and affects the availability of staff to monitor the bank's operations. Therefore *muḍāraba* needs more scrutiny as far as the client is concerned and, hence, this might explain why IBs are so conservative to use it in order to finance medium-and-long-term investments.

Information on the marketability of the products is also important, especially in circumstances of rapidly changing prices and inflation rates. Given the thriving black market in the Sudan, it is difficult for IBs to collect proper information on the market and give finance through *muḍāraba*; banks are likely to extend their finance to those customers whom they know personally, a procedure prompts the management to be more conservative.

(c) *Murābaha*:

Murābaha is not able to absorb all types of lending activities. In funding working capital needs, it can be used for funding raw materials but not other components. This is because *murābaha* is a way of financing tradeable commodities which must be held or delivered at the time of sale.

Thus *murābaha* lacks the flexibility of interest-lending in the case of long-term investments and is probably not used for this type of projects.

Apart from the above problems concerning Islāmic modes of finance, IBs face the difficulty of repayment on time; indeed, in many cases there are no balances to repay.

When customers fail to repay, IBs encounter two problems; first, the money is blocked, obviating its use in other investment projects; and second, unlike traditional banks, IBs cannot claim more profit for the delay, this being *harām* in Islām, i.e. not permissible in Islāic ruling.

● Summary:

Islāmic modes of finance require information on clients and the market so that these modes might be applied adequately. This requirement is particularly important in the case of medium-and-long-term investments. Therefore some IBs managers are discouraged from financing some productive investments either because of a lack of information or because the traditional form of Islāmic mode of finance is not attractive to some investors and is unable to absorb all types of lending activities. Hence the sponsoring of productive investments by IBs is affected by the nature and character of Islāmic mode of finance.

Chapter IX

Islāmic Credit In The Sudan: The Case Of Faisal Islāmic Bank (SUDAN) (FIBS)

The preceding chapters are concerned with the development of IBs in Sudan, their market share, financial resources and contribution to medium-and-long-term investments, and to monetisation of the economy. In this chapter the performance of IBs is examined much more closely by taking the first and leading Islāmic financial institution in the Sudan, FIBS, as a case study.

The chapter is organised as follows, section one covers the establishment of the bank, its capital, subsidiary companies and organizational structure. Section two gives details of the geographical spread of the bank's network and the deposits liabilities compared with commercial banks in general and other IBs in particular. Section three shows the volume of lending activities of the bank, its role in financing different sectors of the economy and, as well, comparing this with other commercial banks including IBs.

9.1 Establishment, Capital and Organization

9.1.1 Establishment

In February 1976, the Saudi Prince Mohammed Bin Faisal discussed with the then president of the Republic of Sudan an idea of establishing an Islāmic bank. Talks resulted in the issue of a special law concerning the proposed bank.

FIBS was established on August 18th 1977, under the '*FIBS Act*'. It started officially on May 10th 1978. The bank was exempted from the application of rules and laws regulating banking services, insurance and payment of taxes on profits and other regulations. These concessions were intended to encourage the bank to compete with the existing banks, but were withdrawn immediately after Islāmization of the banking system in 1984.

Many people were interested in this new type of financial institution and some of them were suspicious about its operations without giving or taking interest. Though the bank was established in a completely interest-based financial system, it performed better than the existing commercial banks. Its outstanding performance convinced the public at large of the applicability and feasibility of interest-free dealings. A number of IBs were opened up partly as a consequence of FIBS' success.

9.1.2 Capital and subsidiary companies

The authorised capital is L.S. 100 millions, of which L.S. 58.4 millions is paid-up.

The bank's capital is divided among Sudanese (40%), Saudi (40%) and other shareholders from different Muslim countries (20%). In comparing FIBS with other IBs, it is obvious that FIBS accounts for one-third of these banks' paid-up capital. The growth rate of paid-up capital is nil over the last five years due to delayed payment of subscription by shareholders³⁷, (Table 9.1).

Table 9.1: IBs: Paid-up Capital (LS. million)

	1985		1986		1987		1988	
	Amount	Annual growth	Amount	Annual growth	Amount	Annual growth	Amount	Annual growth
FIBS (1)	58.4	0	58.4	0	58.4	0	58.4	-
Taḍāmon Islāmic Bank	21.4	.005	21.5	0.11	23.9	0.00	23.9	-
Sudanese Islāmic Bank	19.4	0.21	23.5	0.00	23.5	0.00	23.5	-
Islāmic Co-operative Development Bank	6	0.13	6.8	0.02	6.9	0.00	6.9	-
Islāmic Bank of Western Sudan	8	0.19	9.5	0.00	9.5	0.00	9.5	-
Al Baraka Bank	55.1	0.004	55.3	0.00	55.3	0.00	55.3	-
Total (2)	168.3	0.40	175	0.20	177.9	0.00	177.9	-
(1)/(2)%	34.7	-	33.3	-	32.8	-	32.8	-

Source: IBs: Annual Reports.

³⁷ See Chapter VII, section 7.10

The bank owns five subsidiary companies undertaking different economic activities in insurance, trade and services, construction, clearance and investment. These are: (i) the Islāmic Insurance Company, (ii) the Islāmic Trade and Services Company, (iii) Real Estate Development Company, (iv) the Sudanese Clearance Company and (v) the Islāmic Investment Company (Sudan) which is a joint venture between FIBS and Dār al- Māl al- Islāmi and invest in agriculture and industry only.

9.1.3 Organizational structure

The organization of any institution aims at achieving its objectives and goals. FIBS, as an Islāmic bank, tries to implement a new banking concept in that it adheres strictly to the rulings of Islāmic *shari'a* in the fields of finance and other dealings. However, being an Islāmic bank does not imply that its organization is fundamentally different from other banks. However, the administrative organisation of the bank is as follows:

9.1.3.1 Management

The board of the directors is composed of Sudanese, Saudi and other Muslim countries' shareholders; it is a body in which ownership rights are vested. All the executives are Sudanese.

9.1.3.2 *Shari'a* Supervisory Board (SSB)

As an Islāmic financial institution, FIBS must have not only a board of directors, it has to have also a *Shari'a* Supervisory Board SSB. The Main objective of the SSB is to

'give creditability to the operations of the bank by authenticating their legitimacy from the Shari'a point of view', (Mudawi, A. Yousif, 1984, p. 4).

The SSB enjoys a high degree of independence from the bank management. It is appointed by shareholders in the General Assembly. The bank management refers to the SSB for advice on how to execute operations without contravening *Shari'a* rules.

Two departments are under supervision of the SSB. The first, the *Zakāt* department, is concerned with the collection and distribution of *Zakāt* and donations. The *Zakāt* is due annually on the bank's capital as well as its annual profits and distributed to the needy people as stipulated by the *Shari'a*.

The second department is the legal affairs department. It is responsible for completing legal procedures with customers and settlements in the case of dispute. Investment operations of the bank are concluded under contracts of *muḍāraba*, *mushāraka* and *murābaha*. The legal affairs department consults the SSB on conclusion of these contracts. In most cases the bank agrees with customers on fair solutions to disputes without resorting to formal civil prosecutions.

9.1.3.3 Investment department

The investment department is an important one. FIBS extends its credits on the basis of participation which means sharing the risk of losses as well as profits. As a result, the bank has more involvement in the projects it finances. The department is divided into three subsections: (a) a feasibility studies section which undertakes studies on the projects presented by customers for finance; (b) an executions section which completes procedures for projects that the bank agreed to finance and (c) a follow-up section to make sure that the finance provided is spent in the proper way and to ensure that the project is well-managed. In fact, FIBS has good experience in this regard. Before implementing follow-up, the bank's return on investment projects was quite low, 5 to 6%. When the follow-up was implemented, the results were quite rewarding, (Hamdi, A. A., 1981).

9.1.3.4 Recruitment and training centre

The bank initially relied largely on staff who were experienced in the traditional commercial banks. On joining the bank, they attended intensive courses and sessions on the *Shari'a*, to learn the rules which govern economic activities in Islām. The staff is usually shown the different contracts which govern the bank's operations and were instructed in the legal status of current accounts in the bank, stressing on the difference between the investment deposits in an Islāmic bank and the similar time deposits of traditional banks.

The bank has set up its own training centre which arranges training programmes inside and outside the country as it has close links with training and academic institutions in different parts of the world.

9.1.3.5 Research and statistics centre

The centre is responsible for initiating and carrying out researches on different economic issues. A major part of the research is devoted to the areas of analyzing different forms of Islāmic financing, and investigating the implementation techniques involved in each form of financing. It undertakes also research on the Sudanese economy and the world economy. Moreover, the Centre collects data on all financial activities of the bank, tabulating these data and analysing them regularly.

Other departments function as organisational units for financial and banking affairs, foreign exchange, information and public relations.

9.2 Geographical Distribution, Deposit Liabilities & MarketShare

9.2.1 Geographical distribution of the bank's network

Although the growth of financial intermediaries in absolute terms is essential for achieving economic transformation, the geographical dispersal of their expansion among various regions is central to the realization of full monetization of the entire economy. Unfortunately, the available evidence reveals that banking facilities in the Sudan have almost exclusively been concentrated in Khartoum province. 105 Out of 315 branches operating different banking facilities were placed in Khartoum, i.e. 30% (Bank of Sudan, 1989).

The same applies, however, to FIBS which concentrated its activities in Khartoum, particularly in the first three years. Since 1980 FIBS started to concentrate on providing banking facilities in the rural regions of the country which include the bulk of the inhabitants in the subsistence sector.

Of the 19 branches run by the bank, 9 are in Khartoum province, (Table 9.2). Nevertheless, although 50% of the bank branches are in Khartoum area, they do

Table 9.2: FIBS: Development in Spread & Growth of Deposits (LS. 000s)

NAME OF BRANCHES	REGIONS	1979	1980	1981	1982	1983	1984	1985	1986	m-d 1987
Central Station	Khartoum	16875	28262	68302	127884	13675	95475	96351	91792	97444
Omdurman	Khartoum	5413	12931	13732	23018	30581	33208	34277	37319	53912
Handi-crafts (Omdurman)	Khartoum	00182	02404	4206	7076	9984	12073	20555	23293	2169
University Of Khartoum	Khartoum	00457	01552	05307	08082	11409	10771	14416	15169	21664
Port Sudan	Eastern Region	-	03848	07234	13100	14741	14617	18879	23069	29896
EL-Gadaref	Eastern Region	-	-	03539	05225	05208	07632	08660	09398	11733
United Nations Square	Khartoum	-	-	-	10424	21555	19863	22799	23325	22704
<i>El-muqtaribeen (expatriates)</i>	Khartoum	-	-	-	07564	12345	14893	15216	10879	9644
Kosti	Central Region	-	-	-	-	2932	6448	6459	6727	8109
EL-Obied	Kordufan Region	-	-	-	-	01729	03684	07363	08934	10980
El-faiha (<i>Head-quarter</i>)	Khartoum	-	-	-	-	-	72047	75608	44363	57420
Attbara	Northern Region	-	-	-	-	-	0517	1785	3349	5502
EL-Saggana	Khartoum	-	-	-	-	-	-	04337	07375	14276
Hilat Koko	Khartoum	-	-	-	-	-	-	3402	3981	5095
Juba	Southern Region	-	-	-	-	-	-	0876	05027	3223
Kassala	Eastern Region	-	-	-	-	-	-	05800	06983	11352
EL- Damazeen	Central Region	-	-	-	-	-	-	-	1788	2097
EL- Fashir	Dar For Region	-	-	-	-	-	-	-	3114	4869
Dongula	Northern Region	-	-	-	-	-	-	-	0862	2304
Total deposits	-	022927	048997	102320	202373	257057	290227	336783	326041	447379

Source: FIBS' Quarterly Reports, June 1987.

not limit their services and facilities to inhabitants of the urban areas. The bank's branches provide services to low-income groups from outlying regions.

Up to 1984, 88% of total deposits with the bank originated in Khartoum province. Because of the bank's network spread, this proportion was reduced drastically to 62.5% in 1987, (Table 9.2). Moreover, the bank has recently been licensed to open another four branches in the Western Sudan – the most backward region of the country. FIBS is adopting the strategy of spreading credit activity to a large number of customers in the rural areas.

9.2.2 Deposit liabilities: their structure and growth

The size of deposits with any financial institution is an indicator of its good reputation and performance. One may argue that apart from the good service provided by FIBS, depositors who deal with it may have religious motives as the bank is an Islāmic one. This is only true to a limited extent because if the bank is not competitive in the quality of its services, it will account for only a small market share, (see Chapter VII, section 7.5.2.3). However, the proof for showing the real contribution of FIBS is supplied by disclosing its contribution in saving mobilization. There is, first, a brief account of the bank services offered by FIBS.

- **Accounts**

Current accounts are offered according to the normal banking practices. These accounts are, however, guaranteed by the bank. Current accounts in foreign currencies are also undertaken especially for the Sudanese nationals working abroad (SNWA).

Saving accounts are offered by the bank free of charge. All or any part of the saving deposits may be withdrawn by the customer at request without notice, and there is neither interest rate nor profit paid to depositors.

On holding saving account, a customer is liable for having greater access to bank credit. However, saving account is different from current account in that: (i) the former account could be opened for any amount of money while there is a minimum limit for current account; (ii) there is a cheque book provided for holders

of current accounts while those who open saving accounts are supplied with a book used at counters only.

Investment deposits are also offered. When the bank started the minimum deposit of investment account was L.S. 100. Funds are deposited subject to one year withdrawal notice. They are utilized in the various investment projects of the bank. The bank takes 25% of the profits of investment accounts for its entrepreneurial efforts in administering the funds, that is its reward as *mudārib* (working on capital). If the deposit is withdrawn before an elapse of three months, the customer is not entitled to any profit, (Hamdi, Abd el Rahim, 1981).

In addition to accounts, FIBS undertakes:

- Domestic as well as international bank transfers
- Collection of bills.
- All forms of letters of credits and letters of quarantees.
- Safe custody services are also provided.

FIBS has been successful in providing the normal banking services and, simultaneously, satisfying customers who in the past used banking services on the basis of interest rates. This success is reflected in the growth of its deposits. To demonstrate this for the 1979-88 period, Table 9.3 shows the structure and growth of FIBS' deposits as compared with other IBs working in Sudan.

9.2.3 Deposit structure

FIBS and other IBs

It is clear that, as mentioned in Chapter VII (section 7.7.1.2 and Table 7.16) the major component of IBs' deposits is the current account deposits. However, FIBS is not an exception. The component of its deposits is predominantly current accounts, which was 82.6% in 1979, 64.5% in 1983, 71% in 1985 and 77.6% in 1988. Thus, current deposits are, throughout the 1979-88 period, not less than two-thirds of total deposits, (Table 9.3 (A)).

FIBS' market share of deposits among IBs declined from 147% in 1984 to 102

Table 9.3(A): FIBS & Other IBs Deposit Structure (LS. million)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
FIBS (1):										
Current	19	40	60	128	166	193	239	241	317	392
Saving	1	1	2	8	12	30	38	30	42	52
Investment	3	8	40	66	79	67	59	48	41	61
Total	23	49	102	202	257	290	336	319	400	505
Taḍāmon										
Islāmic Bank:										
Current						26	56	103	155	228
Saving						1	2	5	8	14
Investment						17	19	13	15	16
Total						44	77	121	178	258
Sudanese										
Islāmic Bank:										
Current						12	69	97	167	233
Saving						1	2	4	7	8
Investment						9	14	13	16	18
Total						22	85	114	190	259
Al Baraka amic Bank:										
Current						59	65	75	88	96
Saving						-	-	-	-	-
Investment						13	17	10	13	13
Total						72	82	85	101	109
Co-operative										
Islāmic Bank:										
Current						31	39	52	95	106
Saving						2	4	10	14	10
Investment						7	11	14	11	11
Total						40	54	76	120	127
Islāmic Bank										
of Western Sudan										
Current						15	21	38	45	52
Saving						-	-	1	2	2
Investment						4	8	9	8	8
Total						19	29	48	55	62
IBs Deposits (2) *						197	327	444	644	815
(1)/(2)						147	102	0.72	0.62	0.62

* Excluding FIBS

Source: IBs Reports.

% in 1986 and 62% in 1988. This finding implies two possibilities that: (i) either FIBs and other IBs are hunting the same group of depositors so that some of them

shifted from FIBS to other IBs when they found similar interest-free services or (ii) the other IBs are more efficient than FIBS and are competitive to it. But the fact still remains that FIBS is dominating the market share among IBs.

9.2.4 Deposit growth

(I) FIBS

There was a remarkable increase in the volume of deposits during the first five years, 1979-83, then a decline during the last five years – 1984-88. Total deposits grew by 34.6% over the years 1979-83, 13% over 1984-88 and by 31% throughout the ten-year period – 1979-88. This decline was synchronised with an establishment of other IBs in Sudan starting in late 1983.

Breaking down deposits into their components, one notices the decline of growth rates of current, saving and investment deposits. These growth rates were, subsequently, 55%, 71% and 87% during the first period and were 17%, 12% and -8% during the last five years, (Table 9.3(B)). Thus, investment deposits experienced a negative growth rate, a decline which was attributed to the stringent credit policies affecting deposit raising by all banks.³⁸ It may also be attributed to the establishment of other IBs, extending similar type of services.

(II) FIBS and other IBs

IBs other than FIBS started operation in late 1983. Therefore, to compare FIBS with these banks, only the data for the year 1984 and onwards are relevant.

Growth rates of other IBs' deposits, total deposits and their components, exceeded those of FIBS. The growth rate has been slowed down for FIBS in late years (1984-88) to reflect a more normal rate. But it still remains the fact that growth rates indicate that other IBs have been growing rapidly since they were established, that FIBS lost share primarily to these banks.

Of particular interest is the growth rate of investment deposits. It was -8 % for FIBS, -2% for Tadāmon Islāmic Bank, 15.3% for the Sudanese Islāmic Bank and -3% for Al-Baraka Bank. Hence, the decline in investment deposits of FIBS was greater than that of other IBs. Moreover, even the average growth rates for

³⁸ See the preceding chapters and also see El-Ashker, A. A. (1990).

all these banks collectively were higher than growth rates of FIBS' deposits and their components.

Table 9.3(B): IBs: Growth of Component Deposits

	Type of Account									Total deposits		
	Current			Saving			Investment					
	1979-83	1984-88	1979-88	1979-83	1984-88	1979-88	1979-83	1984-88	1979-88	1979-83	1984-88	1979-88
FIBS	0.55	0.17	0.31	0.71	0.12	0.49	0.87	0.0-8	0.22	0.31	0.13	0.34.6
Taqāmon Islāmic Bank	-	0.53	-	-	0.67	-	-	-0.02	-	-	0.44	-
Sudanese Islāmic Bank	-	0.70	-	-	0.546	-	-	0.153	-	-	0.575	-
Islāmic Bank of Western Sudan	-	0.325	-	-	0.21	-	-	0.142	-	-	0.301	-
Islāmic Co-operative Development Bank	-	0.335	-	-	0.446	-	-	0.09	-	-	0.307	-
Al Baraka Bank	-	0.122	-	-	-	-	-	-0.03	-	-	0.764	-
Average IB	-	0.4024	-	-	0.468	-	-	0.067	-	-	0.477	-

Source: as calculated from Table 9.3(A).

FIBS has announced recently what is called the '*First Saving Scheme*'. It has been designed to attract funds from SNWA, particularly those working in the Gulf Estates and Arab Republic of Yemen. The scheme covers financing of projects presented by SNWA either as individuals, small groups or as a company, and in the field of handicrafts, professions agricultural and animal production. It also covers the establishment of small servicing projects and light industries.

Pre-requisite for the financing are: (1) the opening of a savings account in a foreign currency of any amount; in the event that the account balance reaches U. S. \$ 2000 or more, it may be converted into an investment account; (b) the bank will finance projects in local currency, with the deposit, valued by an official rate for the dollar, serving as a guarantee; (c) the bank will invest the deposit, if converted into an investment deposit. In this case the depositor will be given 70% of profits realized in dollars; he/she can claim back the deposit in dollars by the end of the project's period (FIBS, First Saving Scheme, February 1988).

9.2.5 FIBS & banking system: deposit liabilities

In comparing FIBS deposits with those held by other commercial banks, it appears that deposits of the former grew by 31% while those of the latter grew

by 28% only over the same period, (Table 9.4). However, it deserves mentioning that FIBS' deposits constituted, on average, 10.6% of commercial banks deposits, (Table 9.4). Adding FIBS' deposits to those of other banks, the growth rate was 28% while excluding FIBS', the growth rate was 26% as shown above. This implies that FIBS has contributed positively to the mobilization of savings by the banking system. This finding is not surprising as it is known that FIBS is backed by more than 11000 shareholders, (assuming that there is a correlation between shareholders and savers), (FIBS, Performance Report, 1985).

Table 9.4: FIBS & Commercial Banks: Private Deposits, The Period 1979-1988 (LS. million)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	Growth rate
FIBS (1)	23	49	102	202	257	290	336	322	400	505	0.346
Commercial Banks (2)	529	695	904	1305	1781	1964	3280	4243	4148	4855	0.28
(1)/(2) (%)	4.3	7.1	11.2	15.6	14.4	14.8	10.2	8	9.6	10.4	-

Source: Bank of Sudan Annual Reports; FIBS Reports, relevant years.

Taking the annual growth of deposits of banking system in the Sudan, one notices the declining annual growth rate for all commercial banks, (Table 9.5). Moreover, in comparing FIBS with other IBs working in other (nearly similar environments) countries, annual growth rates indicate that FIBS and Faisal Islāmic Bank of Egypt (FIBE) grew rapidly, with a particularly faster than normal rate of growth in the early years. Their growth rates slowed down in late years to reflect not only a normal rate, but also the impact of policies (monetary and credit policies) in these countries. On the other hand, the Kuwait Finance House (KFH) showed a relatively rapid growth rate in early years since it was established (in 1978) and then a declining trend of growth.

9.3 Investment Activities

An investment is central to any Islāmic bank and it must be given a special attention as the Islāmic bank does not lend money on an interest rate basis. Therefore, it is expected to scrutinize the projects that are selected for finance. The important point in this regard is that investments are undertaken according

to the Islāmic modes of operating. In Chapter II it has been shown the various forms of interest rate which are prohibited by Islām. Chapter III discussed the alternative formula available for investment and financial transactions in the Islāmic framework. In this chapter there is first a brief discussion of the forms of Islāmic modes of finance in connection with the investment activities of the FIBS.

Table 9.5: FIBS & Other Banks: Annual Growth of Deposits

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88
Banking system	0.31	0.30	0.44	0.37	0.10	0.67	0.29	-	-
Government banks	-	0.21	0.28	0.28	0.14	0.63	-	-	-
Joint & Foreign banks	-	0.47	0.61	0.29	(-0.005)	168	-	-	-
(excluding IBs)	-	-	-	-	-	-	-	-	-
All Islāmic banks	113	113	0.98	0.57	0.41	0.33	0.23	0.37	0.21
FIBS	113	113	0.98	0.27	0.13	0.16	(-0.04)	(-0.02)	0.17
FIBE	-	234.8	0.689	0.535	0.258	0.042	(-0.066)	-	-
KFH	-	0.979	0.609	0.475	0.019	0.019	0.047	-	0.09

Source: Bank of Sudan Reports; FIBS Reports; Volker Neinhaus, 1988

9.3.1 Islāmic Investment formulae

IBs do not give or take interest rate in their dealings. They follow either of the following formulas:

(I) *Mushāraka* (Partnership)

Whose main features are that wealth (capital) and labour are held on a partnership basis by both parties (the bank and the customer), the share of each partner in the profits is a general ratio and not a particular rate in relation to the capital. The two parties agree in advance on the ratio into which the net profits are to be divided between them.

For instance, in financing commodity trade, FIBS began in the first years to supply up to 80% of the required funding and the partner supplies the remaining 20% (the ratio varies according to the type of commodities). From the net profits, the partner is given allowances for managing the operation which varies between 20 and 35%. The remainder of the profits is divided between the two parties according to the share of each party in the capital of the operation. From the

point of view of Islāmic law, the ratio of profit sharing can be different from that of capital participation and so the bank usually gives the partner a share in the profits higher than the partner's actual contribution in capital. If, however, losses occur they are borne by the two parties in accordance with their respective shares of the capital.

In financing industry (working capital), FIBS evaluates assets of the partner in cash terms, determines the working capital to supply and agree on the ratios of profits and loss sharing.

In fact this formulae is found more convenient for financing of industry, agriculture, services and trade. The bank studies the operation submitted by the customer for finance, the participation of the customers in the capital and the profits of the operations are determined. The customer must contribute a cash or kind as part of the capital in the case of partnership. A time limit is determined for the termination of the operation. The partner is authorized to manage the operation directly. No security can be taken from the partner as a partner, it is taken against negligence or wilful act by the partner.

There is, however, a problem in connection with the implementation of the partnership, this is how to value the element of labour (management) contributed by the partner. Although this problem is of theoretical nature the bank solved it by determining the contribution of the element of labour according to the type of operation. For instance, exports operations are given a higher management allowance (or incentive) than import operations. Another problem is how to value the fixed assets contributed by the partner.

A third problem which is considered to be the most important is the extension of the operations further than their stipulated time limits. In other banks an additional interest rate is imposed on delayed debts. For an Islāmic bank, if the customer is not likely to liquidate the operation for a reason pertaining to the market, the bank has to accept this and such a situation results usually in a decrease of the real profits of the bank due to the extension of the operation time. To solve this problem, FIBS makes use of the terms stipulated in the contract of the operation and it uses persuasion to facilitate prompt liquidation. Overtime, and after long practice of *mushāraka*, the bank found that it is important to be careful

about the initial evaluation of the projects, the selection of the right partner and the follow-up of their performance and the adoption of effective control mechanisms to monitor operations.

The bank adopts a mechanism of control embodied in the original contract to regulate drawings from the bank's participation in order to avoid the incidence of surplus liquidity in the hands of the customers and to guarantee a continuous flow of repayments. For instance, the partner must submit a contract of purchase or shipment documents before receiving any funds from the bank.

(II) Partnership leading to ownership (leasing)

This is a developed version of the original partnership formula which is suitable for medium-and-long-term operations. A portion of the net proceeds of the operation is deducted and allotted to the repayment of the original trade finance. Another portion is given to the bank as a profit and the third portion to the customer as his profit. FIBS uses this formulae in financing basically craft activities.

(III) *Muḍāraba* (Quirād)

Muḍāraba is a contract between two parties according to which one of them pays the other a specific amount of money (capital) to invest for an agreed general ratio of the net profit. This contract is characterised by the fact that all the capital comes from one party (*rabb ul- māl*) and the labour (i.e. management) comes from the other party, the *muḍārib*. The net profits are divided between them according to the ratios agreed upon in advance in the contract. The profit due to each party must not be a rate determined in relation to the capital but a ratio out of the realized profits. The difference between this mode and the partnership is that here all financial loss is borne by the capital owner only unless it comes from the negligence of the *muḍārib*. This is why the bank regards this formulae as more risky and uses it in operations closely supervised by the bank such as exports operations.

Muḍāraba can be absolute (unconditional) or restricted (conditional). The bank uses the absolute form in its relationship with the holders of investment deposits, and the bank acts as *muḍārib*. The depositor signs a written undertaking authorizing the bank to invest deposits according to unconditional *muḍāraba*, and

it does not guarantee repayment of all or part of these deposits in case of losses. In this way the bank has the right to determine the field and method of investment.

In giving finance to the customer, on the other hand, the bank uses the conditional formulae, acting as an owner of capital *rabb ul-māl*. It takes from the *mudārib* a collateral to guarantee good management (i.e. avoiding negligence or misbehaviour) or the customer keeps the goods concerned in the bank's stores. The bank regulates withdrawals from the *mudāraba* operation account, and it applies also the repayment control mechanism.

(IV) Sale by instalment

Many Muslim jurists regard a selling price in cases of instalments to be *halāl* when it is set higher than in the case of cash sale on stipulation that if the customer does not pay the instalments in the specified time, the price cannot be raised, and payment should be delayed.

The bank is now using this formula with extremely soft terms to finance small instruments of production for craftsmen, like lathes, saws and sewing machines as well as commercial vehicles including trucks, pick-ups and tractors.

(V) *Murābaha* (sale for profit)

The *murābaha* formulae implies an ordinary sale of a commodity for a profit over and above the original price at which the bank has purchased it. Certain conditions are to be fulfilled in the *murābaha* sale: that both parties should know the original purchase price, the profit sum or rate and there should be no interest already included in the original purchase price.

FIBS is using this formula in financing local and foreign trade operations. The sale can be ended by handing over the shipping documents in case of imported goods. A *murābaha* contract does not commit the customer to buying of any commodity he demanded and is made available to him even if it satisfies the conditions he has asked for.

The bank does not take a collateral if the customer received the goods and paid for that instantly. If the commodity is imported, the customer is asked to sign an undertaking giving the bank the right to clear the commodity through

customs and sell it in case the customer rejected it. If payment for the commodity is by instalment, the bank asks for the real estate mortgage, or the security may be partly a real estate mortgage and partly the storage of the commodity at the bank's warehouses, or a personal security by a third party. Up to 1985 the bank did not take deposits in advance from a customer. But then the Central Bank, in order to control money supply, asked IBs to take 25% of the value of any commodity to be paid in advance by a customer to the bank. However, the *murābaha* formulae is accepted by customers because it is simple and allows them the freedom in selling goods.

(VI) *Quard hasan* (Benevolent loans)

These were made available to the bank's partners as an interest free overdraft if they are faced with difficulties or unexpected needs. They were also used as an incentive for good customers. The bank used to give benevolent loans also to semi-government corporations and needy people. However, in early 1985 the Central Bank of Sudan prohibited an extension of benevolent loans by IBs.

9.3.2 Profit margins

The bank's policy is not to help raise prices and so it does not finance the purchase or storage of the local commodities unless the purchase is from original sources and not through intermediaries. It also conforms to the legal profit margins for different commodities and services as determined by the state, and the bank's ratio of profits is therefore determined as a percentage of the legally fixed prices.

As is shown above, FIBS finances investment operations according to the Islāmic contracts of *mushāraka*, *muḍāraba*, *murābaha*, *ijāra* and other forms of Islāmic finance. It takes different profit margins depending on the types of the commodities and the clients.

For some essential commodities financed on *murābaha* (mark-up) the bank takes lower profit margins. For non-essential commodities it takes higher profit margins. Table 9.6 shows the various profit margins taken on *murābaha* operations in different economic sectors, and according to the payment of instalments. It is clear that profit margins vary according to the type of a commodity and the time span of an operation.

Table 9.6: FIBS: Instalment & Profit Margins Structure

	Payment of instalment (months)	Profit margin%
(I.) Finance of local trade:		
(a) instalment every month	1	2
(RP* 1-3 months)	2	4
	3	4.5
(b) instalment at the	2	4
end of the period	3	5.5
(RP 2-3 months)		
II. Finance of foreign trade	6	13
(local & foreign component)		
Finance of working capital	3	4.5
and raw materials	6	10
(RP 3-12 months)	9	13.5
	12	18
Finance of agricultural machinery and equipment:		
(a) Annual instalments	1 year	15
(RP 1-3 years)	2 years	25
	3 years	35
(b) half-year instalment	1 year	15
(RP 1-3 years)	(two instalment)	
	2 years	25
	(four instalment)	
	3 years	34
	(six instalment)	
Finance of trucks and	1 year	18
buses	2 years	25
(RP 1-3 years)	3 years	36

Source: FIBS: Investment Department.

* RP = Repayment period.

In *mushāraka* (partnership) the management allowance varies between 20 and 30% of the net profits. The management allowance may rise up to 50% in the case

of *mudāraba*, (Hamdi, Abdel Rahim, 1981).

9.3.3 The risk element in bank's investments

Risks arise in finance operations either because of the nature of the finance formula themselves or because of the economic circumstances under which IBs work.

The risks inherent in the formulae are that the partner enjoys a great deal of control over the operation (either as a partner or as a *mudārib*) according to the Islāmic formulae which gives him the right to act, and according to the bank's policy of authorizing the partner to manage the partnership operation for himself and the bank, (Hamdi, Abdel Rahim, 1981, p.17). There is also the moral commitment on the bank to facilitate the procurement of the means of production to the small-scale producers which causes the bank to lower securities offered by the small producers.

The risks arising from the environment include the difficulty to determine appropriate profit-sharing ratios in advance for both the bank and the customer. The customers sometimes do not understand the Islāmic investment formulae, but in practice the risk arising from this decreased over time when customers continued being financed by the bank on Islāmic modes of finance and they have become acquainted with the conditions of these modes. Another source of risk is the customers tampering sometimes with figures and records they are entrusted with.

In order to reduce the risk involved in investment operations, FIBS adopts the following procedures:

(i) It undertakes technical and economic studies of each operation carefully and investigates the customer's financial position and dealings. In addition there is continuous supervision and follow-up of the operation.

(ii) The control of funds coming into and out of the operation through the determination of the methods and conditions of withdrawals and repayments, with a view to enable the bank to make sure of the suitable allocation of its funds. The

bank has introduced also a fund reserves for losses equalization which is used to cover the losses.

The bank asks for physical or personal securities by a third party in favour of the customer who, i.e. the third party, signs undertaking to pay the amounts due to the bank if the original customer defaults.

FIBS insists on securing its operations in accordance with *Shari'a* stipulations. As mentioned above, actual security in the form of a mortgage is needed to secure competent performance by the partner. Moreover, the withdrawal mechanism used by the bank to regulate investment operations is designed to fit the special nature of each operation so that some flexibility is maintained for the partner to conduct the operation.

As a matter of policy, FIBS tries to take collateral for all operations. The different forms of security, physical mortgage, storage of goods, personal security and others, are usually taken separately or collectively to provide full security to the bank's operations. Losses resulting from reasons other than negligence or breach of contract by the partner are shared by the bank and the customer in proportion to contribution of the bank and the customer.

9.4 The Allocation of Generated Deposits

9.4.1 Investments and deposits utilisation

(I) FIBS and other IBs

As mentioned earlier, an investment is central to any Islāmic bank and must be given special attention as the Islāmic bank does not lend money on an interest-rate basis. Accordingly, FIBS concentrated on a selective investment policy to realize objectives of both the depositors and shareholders, and to enable the bank to contribute positively to the socio-economic development of the Sudan.

The growth rate of FIBS' investments was 27.4% during the period under review – 1979/1988. The data on Table 9.7 below show that FIBS' investments witnessed a steady increase annually up to 1984, declining in 1985 and began increasing again. The growth rate of FIBS' investments during the five-year period

1984-88 was lower than that of other IBs. As, however, FIBS started operations five years earlier than these banks, the lower growth rate of its investments might be regarded as a normal rate. Moreover, FIBS is among IBs which utilise their deposits at lower rate.

Table 9.7: FIBS & Other IBs: Credit Growth & Deposit Utilisation

	1984	1985	1986	1987	1988	Growth rate
FIBS (1)	133*	120	158	192	241	0.166
	(0.46)*	(0.38)	(0.49)	(0.48)	(0.48)	-
Taḍāmon	22.3	26.7	24	38.2	67.1	0.256
Islāmic Bank	(0.51)	(0.35)	(0.20)	(0.39)	(0.26)	-
Al-Baraka Bank	25	32	50.4	70	84	0.32
	(0.35)	(0.39)	(0.32)	(0.33)	(0.37)	-
Islāmic Bank of	7	17.8	17.19	33.7	40.5	0.414
Western Sudan	(0.37)	(0.61)	(0.56)	(0.61)	(0.65)	-
Sudanese Islāmic	14	40.1	55.68	146	155	0.61
Bank	(0.64)	(0.59)	(0.48)	(0.77)	(0.60)	-
Islāmic Co-operative	43.2	60.4	73.6	74	121	0.073
Development Bank	(108)	(112)	(0.97)	(0.62)	(0.96)	-
Total (2)	104.5	187.2	316.6	361.9	467.6	0.37 (33)*
(1)/(2)	127	0.64	0.50	0.53	0.515	-

* In LS. million; * values between brackets indicate degree of deposit utilisation

* 0.33 is the average IBs growth rate

Source: IBs Reports, relevant years.

As a percentage of other IBs' investments, FIBS' investments decreased from 127% in 1984 to 64% in 1985 and 51.5% in 1988. The decrease in its share was attributed to an establishment of other IBs. It was also attributed to the government policy of containing money supply and credit and an adoption of the IMF stabilisation programmes and financial reforms. FIBS and other IBs could no longer find profitable outlets to finance from their resources.

When calculating growth rate of investments for the first five years of the bank's operations, it was 58.6%, but investments experienced a slow growth during 1984-1988. This slow down was synchronised with an expansion in Islāmic banking services provided by similar IBs which started operations in the second half of 1983. That is the market share of FIBS among the section of customers who prefer IBs' services was reduced. Another cause of the decline was the restricted credit and monetary policies adopted by the government to restore internal and external imbalances facing the Sudanese economy.

(II) FIBS and commercial banks

In comparing FIBS' investments with commercial banks' advances, investments of the former constituted only 2% of advances of the latter in 1979. This percentage increased steadily overtime till it reached 10% in 1982 and 1983. Since then, FIBS' investments have been declining and constituted only 6% in 1986, 5% in 1987 and 5.5% in 1988, (Table 9.8). This decline was attributed to the causes mentioned earlier.

Table 9.8: FIBS & Commercial Banks: Credit Growth & Deposit Utilisation

Years	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	Growth rate (%)
FIBS' investments (I_{fibs})	12	57	84	136	125	133	120	158	192	241	23.3
FIBS' deposits (D_{fibs})	23	49	102	202	257	290	336	319	400	505	34.6
I_{fibs}/D_{fibs}	0.52	0.65	0.56	0.51	0.49	0.46	0.38	0.49	0.48	0.48	-
Commercial banks:											
advances (A_{com})	449	561	778	1143	1377	1609	1777	2637	3793	4345	25
deposits (D_{com})	529	720	943	1340	1781	2064	3623	4243	5786	6206	28
A_{com}/D_{com}	0.85	0.81	0.80	0.80	0.70	0.75	0.51	0.59	0.66	0.70	-
I_{fibs}/A_{com}	0.02	0.06	0.08	0.10	0.10	0.09	0.07	0.06	0.05	0.06	-

Source: Bank of Sudan Annual Reports; FIBS' Reports.

Taking the growth rate, one notices that FIBS' investments grew by almost the same rate as advances of the banking system. Growth rate of FIBS' investments was 27.4% while that of commercial banks was 25%. On the other hand, although deposit growth rate for FIBS exceeded that of commercial banks, 34.6% for the

former and 28% for the latter, deposit utilisation for FIBS was throughout the period lower than the country average of deposit utilisation.

9.4.2 Financing of productive sectors

It is natural that any new financial institution should be involved in short-term financing at the outset. This is necessary for two reasons: first, to enhance its financial position; and second, to encourage depositors and shareholders by giving them rewarding return.

FIBS adopted this policy, but at the same time it did not ignore the importance of long-term financing. Therefore in its second year in operation the bank financed two oil mills, and designed plans for financing productive projects in the medium and long term. The details of this are broken down by sector as follows.

9.4.2.1 The industrial sector

FIBS gave more attention to industry through *mushāraka* (partnership) contracts which are more appropriate in providing capital to this sector. Following this form of financing, the bank achieved what can be called an alliance between capital and work, which resulted in the bank having a stake in industrial concerns it financed. Moreover, it played a positive role instead of acting as a creditor only.

The amount of funds provided to this sector totalled L.S.74 millions over the years 1979-1987. It was used in buying raw materials, machines and equipment and as working capital for different industries. A special interest was shown in the oil mills industry which witnessed a remarkable increase in the early 1980s. To bridge the gap between local consumption and production, the bank helped this type of industry, especially oil seeds production in the rural areas. The total amount of credit was L.S. 15 millions up to 1984.

In 1983, FIBS diversified its industrial investments. It started as a provider of capital for different long-term projects. These included food factories, printing presses, drugs factories; spare parts for Port Sudan Petroleum Refinery, sugar factories, the railways corporation and other public and private industrial concerns.

However, the bank's contribution might have been more impressive than its accomplishments had certain problems been solved. These are a number of obstacles to the promoting industry: (a) a lack of enthusiastic and competent entrepreneurs to set up and operate manufacturing firms and (b) constraints connected with the investment environment, including inappropriate economic policies and structural rigidities.

9.4.2.2 The agricultural sector

The Sudanese economy is basically agricultural with activities in this sector dominating over those of other sectors. The potentials for development lie in agriculture. The bank planned therefore to contribute significantly in promoting this vital component of the economy.

Between 1980 and 1982 FIBS allocated L.S. 4 millions to the rainfed agricultural sub-sector. Over 300 tractors and ancillary equipment were sold to farmers on concessionary terms. It helped in marketing agricultural products, both locally and in the world markets. Participation in promoting agriculture also included the provision of fuel and petroleum products whose scarcity is a real problem facing farmers during the rainy seasons, especially those in rainfed areas, (FIBS Quarterly Review, 1984).

To expand and modernize the agricultural sector, FIBS imported production goods worthy an equivalent of L.S. 51 millions, over 80% of which were agricultural machinery, water pumps and tractors. Moreover, the bank imported spare parts with a value of U.S.\$ 27 millions for public corporations undertaking agricultural investments on a large scale such as the Sudan - Egyptian Company for Agricultural Integration and the El Suki Agricultural Corporation; the bank also met their demands from imported insecticides and fertilizers.

In 1983, FIBS started medium-term financing. It granted interest-free loans (*quard hasan*) to a number of agricultural corporations. More important is the bank's investment of LS 6.25 million in the Damazin project for agricultural and animal production. Another two projects that were supported are in Northern Sudan: the El Tibaylab project, which extends over an area of 10,000 feddans,

and the El Hasa agricultural project. The bank entered in the latter by buying the Agricultural Bank share which was LS 700,000; it also financed running costs.

Total investments in agriculture reached L.S. 37.3 millions in 1986, while they were L.S. 6.3 millions in 1985. Part of the funds provided were directed to import insecticides, seeds and other agricultural inputs.

9.4.2.3 Transport and services sectors

One can state without hesitation that the contribution in this area was quite remarkable and outstripped that of other banks. FIBS imported 1300 freight transport trucks whose value was U.S.\$ 12 million and coaches worth more than U.S\$ 6 million.

The bank shared in the establishment of one successful company working in passengers transport which links the capital with different regional and rural areas.³⁹ It owns 60% of its capital (L.S. 25.5 million). Moreover, it owns shares in a number of companies transporting petroleum products, including Trans-national Transport Company, and air-cargo companies that work between the South and the North of the Sudan.

9.4.2.4 Financing of small-scale industry

The theory of economic development demonstrates several inter-related positive characteristics of small industries. Many studies show that as compared with large industries, small-scale industries' activities are more labour-intensive. They generate income on a large scale; they are less capital-and-import intensive, they cater for local, especially low-income markets, and are more geographically dispersed.

These characteristics lead to the conclusion that small-scale industries might play an important role in the Sudan at its present stage of development. Therefore FIBS has a strong desire to promote them.

The bank opened a specialized branch in one of the biggest industrial areas in Khartoum to provide handi-crafts and artisans with their equipments either

³⁹ Attaysir Trandport Company.

from local markets, or by importation. The branch extended its credit activities to low-income groups of taxi drivers and micro-bus and coach drivers who in the past worked as salaried drivers, (see the next chapters).

9.4.2.5 Trade finance

Because of the unavailability of foreign currency, the government is unable to finance importation of necessary consumer goods. In this regard FIBS played a vital role using its foreign resources and facilities in importing basic commodities. Special considerations were given to commodities that are largely used by low-income groups.

The bank imported fuel, foodstuffs, chemicals and drugs. For instance, it imported 140,000 tons of wheat from the United States, excluding the finance of production and transportation of *dura* (sorghum) to areas of consumption. Between 1980-84 it imported petroleum products whose value totalled LS 197 million, flour, wheat, lentils, rice, powdered milk, and other foodstuffs with a value of LS 59 million. Apart from this, the bank brought from abroad chemicals and drugs worth LS 55 million, excluding the amount paid to import raw materials for some industries. It paid, moreover, LS 61 million for building materials, timber, and carpentry inputs.

9.4.2.6 Exports finance

In comparing the value of exports financed by FIBS with the whole economy's exports, one will find that exports financed by the former constituted 14.2% of the latter's, on average.

Investments in exports decreased drastically. They slowed down to L.S. 4.6 million in 1985, and to L.S. 2.6 million only in 1986. The main reasons for this are: (i) an increase in costs of production of the Sudanese exports, (ii) a decline in production and deterioration in quality of exportable products, (iii) less demand abroad for Sudanese exports and changes in the conventional markets of the Sudanese exports, (iv) producers are discouraged by paying them with the official rate of the Sudanese pound (L. S. 2.5 per a dollar) which is too lower than the free

market exchange rate, and (v) finally the prohibition of exporting sorghum, *dura* in 1986. (Table 9.9 portrays investments distributed among sectors.)

9.4.2.7 Social welfare

It has been pointed that FIBS set up a separate department concerned with the collection of *Zakāt* and donations, and distribution of these funds to needy people. Within five years the bank distributed about L.S. 10.5 million as *Zakat* and LS 8 million as donations. In addition, the bank paid LS 9.74 million as taxes to the public treasury. The bank's labour force is now approaching 1000 employees, including workers, secondary schools leavers and university graduates. However, the social role is considered as complementary to participation of the bank in economic development.

9.4.2.8 Attraction and mobilization of foreign currency

FIBS was successful in attracting hard currencies either through an increase in the foreign component of capital and deposits or by financing exports. Remittances of foreign currencies to FIBS increased from U.S.\$ 31.4 million in 1979 to U.S.\$ 749 million in 1984. It deserves mentioning that the bank's capital is owned by 11049 shareholders distributed as 10107 from the Sudan, 861 from Saudi Arabia and 441 shareholders from other Muslim countries. 60% of its paid-up capital is in dollars.

As a result of its good performance, FIBS mobilized enormous foreign currency deposits that totalled U.S.\$ 768 million in 1983 and U.S.\$ 639 million in 1984. Moreover, it was given by some banks overdrawing facilities not less than U.S.\$ 35 million over the indicated period, without being charged interest rates. Fortunately, it used these facilities to the utmost in marketing national exports in the world market.

In addition, total foreign remittances to FIBS from paid-up capital, deposits and free-charge allowances by foreign banks formed 54% of the economy's foreign currency remittances from foreign trade over the period 1979-1984, (table 9.10). After 1984 the Central Bank imposed restrictions on commercial banks (excluding government banks) to deal in foreign currency, especially remittances.

Table 9.9: FIBS: Investment Distribution by Type of Commodity
The Period 1980-87 (LS. million)

	1980		1981		1982		1983		1984		1985		1986		1987		Total	
	Value	Bank share	Value	Bank share	Value	Bank share	Value	Bank share	Value	Bank share	Value	Bank share	Value	Bank share	Value	Bank share	Value	Bank share
Petroleum products	-	-	21	11	21	16	-	-	71	18	1	1	1	1	-	-	115	47
Chemicals	3	3	12	12	27	24	15	13	4	3	7	6	8	5	5	4	74	64
Industrial inputs	15	10	13	8	22	22	5	12	5	4	7	6	42	33	8	7	111	97
Agricultural machinery	2	1	6	5	8	7	12	10	25	21	17	16	15	8	41	41	122	101
Transport & services	2	2	17	12	25	16	11	9	11	10	4	3	12	11	18	15	97	77
Spare parts	10	6	5	3	6	4	10	9	13	8	7	6	5	5	16	15	64	52
Raw materials	4	4	2	2	3	3	2	2	2	2	17	17	23	19	47	39	92	84
Building materials	11	7	6	6	22	17	14	10	6	4	15	13	16	11	5	4	91	70
Foodstuffs	3	3	4	3	21	12	27	25	22	18	16	14	16	16	18	18	117	99
Crops	19	15	12	10	7	6	18	16	21	18	26	20	23	17	38	33	152	125
Electric equipments & electronics	2	1	1	1	2	1	1	1	1	1	1	1	1	1	-	-	9	7
House utensils	1	1	3	2	4	2	12	10	3	2	1	1	1	1	-	-	20	14
Spinnings	3	2	2	2	3	2	5	4	2	1	3	3	3	3	2	2	23	19
Others	3	2	7	5	7	4	6	4	52	23	14	13	22	8	23	13	128	66
Total	78	57	111	84	178	136	148	125	334	133	136	120	183	139	221	191	1215	922
Total Operations		779		1471		1631		1141		1366		2118		1891		3374		13971

Source: FIBS, Special Reoprt, 1989

Table 9.10: FIBS: Foreign Currency Remittances & Sudan Total Exports Proceeds, The Period 1979-84 (LS. million)

YEARS	1979	1980	1981	1982	1983	1984
FIBS paid-up capital(1)	04	06	10	16	36	36
FIBS private deposits(2)	06	44	159	221	768	639
FIBS facilities from foreign banks(3)	07	21	44	67	42	42
FIBS exports proceeds(4)	18	36	66	103	50	32
FIBS total foreign currency remittances(5)	31.4	107	279	406	899	749
Sudan exports proceeds(6)	458	694	488	295	372	n.a.
(4/6)%	03.8	05.2	13.5	34.9	13.4	n.a.
(5/6)%	06.8	15.4	57.2	137.6	241.7	n.a.

n.a.= not available.

Source: Bank of Sudan Reports; FIBS Reports, relevant years.

9.5 FIBS: Overall Performance

9.5.1 Performance: an overview

For an assessment of the quantitative importance of FIBS, its market share has been shown earlier in this chapter. Using the assets side for the same purpose, it is obvious that the bank built up its assets rapidly till it became the second largest bank of the country since 1984. Though it was the fifth bank in 1980, within five years it occupied this second rank with respect to assets, (Table 9.11). The capitalization of the bank in relation to its total assets ranged from 8% in 1980 to 30% in 1983.

9.5.2 Revenue, profits, and returns on deposits and shares

During its first five years, 1979-83, the bank's revenue grew at a rate higher than the expenditure rate, (Table 9.12). This high rate slowed down after 1983. According to what is shown by the statistical figures, if revenue had grown by the same rate experienced in the first five years, the bank's financial

Table 9.11: Assets & Capital/Assets Ratios, The Period 1980-85 (LS. million)

	1980	1981	1982	1983	1984	1985
Assets:						
FIBS	67	138	275	440	447	480
Bank of Khartoum	315	452	759	1049	1200	1647
Unity Bank	186	243	313	367	409	348.5
El-Nilien Bank	301	291	366	410	463	-
Sudanese Commercial Bank	86	119	101	176	198	162
(K/A) _(fibs)	0.08	0.08	0.10	0.30	0.30	0.27
(K/A) _(com)	0.02	0.03	0.04	0.07	0.08	0.05
(K/A) _(gbs)	0.03	0.02	0.03	0.04	0.04	0.04

(K/A)_(fibs) capital/assets ratio for FIBS

(K/A)_(com) capital/assets ratio for all commercial banks

(K/A)_(gbs) capital/assets ratio for government banks

Source: Commercial Banks Reports.

Table 9.12: FIBS Revenue Components, Expenditures, Profits & Returns (LS. million)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	Growth rate	
											1979-83	1979-88
Direct investments	879	2606	8039	15045	9901	12224	20105	1380	21188	22084	66	0.22
Banking services	231	1070	2238	3792	8257	3893	5337	4005	6234	9712	0.84	0.30
Foreign exchange	1221	1163	3170	8472	10670	3054	4758	1506	0868	8667	0.63	-0.7
Others	14	131	612	1126	4749	228	641	673	3659	5135	0.78	0.36
Total revenue	2345	4969	14095	28356	36279	19399	27841	26564	31949	37798	0.72	0.25
Expenditures	1200	2300	3700	7400	12200	10300	12619	17380	18312	23202	58	30
Total profits	1145	2669	10395	20956	24079	9099	18222	9184	13637	14596	58	26
Shares return (%)	15	20	25	25	18	12	16	6	1	3	-	-
Investment deposits return (%)	14.7	16	15	15	10	5	9	8	9	7	-	-
Bank interest rate (%)	8	8	9	12	15	n.a.	n.a.	n.a.	n.a.	n.a.	-	-

n.a.= not available

Source: FIBS Reports, relevant years.

position would have been much better. Actual figures were LS 19.4 million in 1984,

LS 27.8 million in 1985, and LS 26.6 million in 1986. Expected figures, estimated in the light of the revenue growth rate in the first five years, were LS 48 million, LS 63 million, and LS 83 million in the indicated years respectively. This fall in revenue could be interpreted by a number of factors such as competition from other IBs, credit policy, and structural inflexibilities characteristics of the Sudanese economy which have obstructed an efficient allocation of resources. Thus, one can notice the sharp decline in growth rate of income in the years 1983/1988 which led to a decline in growth rate from 72.2% during the first five years of the bank's operation to 14.8% over the 1979-88 period.

FIBS, like other IBs elsewhere, when first launched in the late 1970s and early 1980s, made huge initial profits, but that its performance deteriorated in the mid-1980s. However, because FIBS is more dependent for revenues on short-term trade financing, it suffered like other IBs more from the credit policies restricting trade finance.⁴⁰

Looking at the component sources of income, the substantial contribution of direct investments in raising income to the bank is evident. The average percentage of investment contribution was 53% over the period 1979-1988. This was followed by foreign exchange transaction revenue, which constituted on average 24% of the bank's income. Despite their remarkable growth during the first five years of bank operation, foreign exchange transactions witnessed sharp decline during the last five years. This decrease was prompted by restrictions on foreign exchange dealings imposed by the Central Bank. It was also attributed to the expansion of informal (black market) buying and selling of foreign currency. Banking service revenue amounted to 17%, and finally other sources (like the bank's share in other IBs) produced 6% (Table 9.12).

FIBS expenditure has risen considerably, especially in the first five years. This rapid increase in expenditure was attributed to the increased spending on branching, depreciation, and maintenance of assets and administrative expenses, (Table 9.12).

⁴⁰ Professor Moore interpretes this deterioration in Islāmic banks performance as, first, Islāmic banks are more dependent on revenues from short-term finance, and this was affected by economic recession in the Gulf which radically cut imports into the region, and, second, Islāmic banks tended to accumulate risky debts without taking adequate provisions for nonperforming loans. See Moore, Clement H., (1990).

As mentioned earlier in this section, the bank achieved high rates of income in the first five years, and thus a high profit rate, 36% during this period. Profits recorded a remarkable decrease in 1984 and fluctuations in the last four years 1985-1988. This decline in profits was a consequence of obstacles that have been constraining direct investments in the last years.

When profits fell, returns on shares were reduced to 12%. Depositors were also affected to the extent that returns on their deposits were only 5% in 1984, 1% in 1987 and 3% in 1988. On the other hand, returns on available resources for investment (deposits, capital, and reserves) were very low. The returns increased, though insignificantly, up to 1982; since then they began falling. In fact, in 1983 the Bank of Sudan blocked banks' resources by asking them to keep at least 10% of their deposits as cash balances.

9.5.3 Returns on equity and assets

Market share of FIBS has been shown in the preceding sections. However, the increasing financial potential of FIBS would hardly be of great use if it is used in a less efficient way than conventional banks. To measure profitability, net income/equity ratios are calculated for FIBS and government banks over the period 1980-85. Net income is calculated as the total income less operating expenses, depreciations and provisions. It is the net income which is liable to distribution between depositors and shareholders. Net income/assets ratios are also calculated to disclose returns in investments.

From the first instance, the net income/equity ratio indicates that FIBS was less lucrative to its owners *if* compared with the government banks, (Table 9.13). This will not mean, however, that FIBS was less efficient than the government banks. The interpretation for this low ratio in the case of FIBS is that its equity (paid-up capital and reserves) is equal to multiples of that of government banks. It is clear that the decreasing trend of net income/equity ratio was due to, first, an increase in capital for FIBS and, second, a decrease in total income for all banks, including FIBS. It seems that until 1982 FIBS was indeed paying more to its depositors than the other banks, but then, as its revenues diminished, it could no longer keep up, (Table 9.12).

Table 9.13: FIBS & Government Banks: Net Income/Equity & Net income/Asset Ratios (The Period 1980-85)

	1980	1981	1982	1983	1984	1985
$\frac{Y_{fibs}}{E_{fibs}}$	0.54	0.63	0.57	0.18	0.7	0.14
$\frac{Y_{fibs}}{A_{fibs}}$	0.05	0.08	0.08	0.06	0.02	0.04
$\frac{Y_{kb}}{E_{kb}}$	200	366	191	330	81	115
$\frac{Y_{kb}}{A_{kb}}$	0.03	0.05	0.03	0.03	0.01	0.02
$\frac{Y_{ub}}{E_{ub}}$	175	280	200	140	86	119
$\frac{Y_{ub}}{A_{ub}}$	0.04	0.6	0.06	0.04	0.03	0.05
$\frac{Y_{acb}}{E_{acb}}$	100	150	100	133	86	222
$\frac{Y_{acb}}{A_{acb}}$	0.05	0.05	0.05	0.05	0.03	0.12
$\frac{Y_{enb}}{E_{enb}}$	100	233	250	400	416	n.a.
$\frac{Y_{enb}}{A_{enb}}$	0.02	0.05	0.04	0.06	0.05	n.a.

Y = income; A = assets; E = equity.

Source: Commercial Banks Reports.

If, on the other hand, the net income/assets ratio is calculated to ascertain returns on investments, FIBS exceeded the government banks throughout the period under review. This is more important because whenever the ratio is high this means that the resources available (including deposits) have been used effectively and that both depositors and shareholders will get high profit margins.

● Summary

FIBS is among the first leading IBs established in different parts of the world, and also the first Islāmic bank in the Sudan. It is also among the top 100 Arab banks, (Moore, C. H., 1990).

It takes about one-third of paid-up capital of IBs working in Sudan. Although it is concentrating in urban area, FIBS' branches are also spreading in rural areas.

FIBS accounts for about two-thirds of deposits of the Sudanese Islāmic banks, and about one-tenth of deposits of commercial banks. Despite the considerable growth of the bank's deposits during the first five years of its operation, deposits growth rate slowed down after 1984. This decrease was synchronised with a start

of other IBs also providing banking services on interest-free basis. The negative impact of stringent credit policies on deposit growth was tangible. This negative impact is particularly considerable on investment deposits. Despite their success in collecting deposits, however, Islāmic banks in general seem to have experienced difficulties in placing the funds in profitable projects.

FIBS uses Islāmic modes of finance to allocate its resources in investment activities. The various profit margins taken on operations vary according to the type of commodity and sectors. If the commodity which needs finance is a necessary one, or the project to be financed is in productive sector, profit margins are preferably low.

FIBS accounts for 51.5% of total investments of other IBs in the Sudan. Its investments were declining as a result of both strict credit policies and due to the establishment of other IBs. It accounts for around 5.5% of total advances of commercial banks.

During its first five years of operation, 1979-83, the bank's revenue grew at a rate higher than the expenditure rate. This rate slowed down after 1983. The component source of revenue were direct investments, foreign exchange transactions, banking services and revenue generated by participation in capital of other IBs.

When profits fell, returns on shares were reduced. Depositors were also affected, returns on deposits being only 2.3% in 1988, less impressive than in early 1980s.

Chapter X

Small-scale Industries (SSIs) In The Sudan

10.1 Introduction

Rapid industrialisation has for several decades been regarded as an attractive and effective strategy for transforming developing economies and maximising their rates of economic growth. Indeed many developing countries began in the early 1950's to launch industrialisation drives based generally on an import-substitution strategy, which usually resulted in the establishment of large-scale capital-intensive industries in urban areas. In recent years, however, it has become apparent that this strategy has often produced disappointing results. In a number of developing countries not only has the overall rate of growth of the economy been low but employment in the industrialisation has failed to keep pace with population growth and in some cases even declined in absolute terms (Frank, C. R., 1968).

The Sudan experience with industrialisation has been similar to that of other developing countries. Sudan's industrial sector is facing many difficulties:

(i) The sector needs foreign currency to get input needs for sustaining a capacity utilisation which is now less than 25%. Because of the unsolved issues between the Government of Sudan and the IMF, the foreign exchange situation of the country is poor and unsatisfactory.

(ii) The sector is extremely import-depedent because of the technologies chosen in the 1960's and especially the 1970's; the structural change of industry since independence (in 1956) has favoured more and more those branches with higher import-content, especially the production of luxury consumer goods.

(iii) The insignificant export industries producing edible oil and yarn are under pressure, especially with lack of adequate fixed capital input.

(iv) The industrial policies adopted since independence have favoured large-scale and capital-intensive industrial ventures at the expense of small- and medium-scale firms.

(v) The industrial public sector has failed to realise even modest targets in providing goods as projected and realising development objectives like equity, regional balance, employment and resource use.

However, the results of all this proved to be disappointing. On the other hand, the SSIs sector is, presumably, characterised by some development advantages: (a) low import-dependency; (b) high employment generation; (c) use of appropriate technologies, (d) generation of local skills; (e) supply of needed goods and services for local and rural markets and stronger linkages to the agricultural sector.

In this context the SSIs need investigation in order to understand their problems, perspectives and the contribution that they can possibly make to industrial growth and economic development. However, given the assumed development advantages of SSIs, this chapter and the next one address basically the question related to their financing. Therefore, section 10.2 gives a theoretical background concerning the financing of SSIs. Section 10.3 gives a historical and institutional policy review as related to SSIs development in the Sudan so as to understand the policy constraints affecting this sector.

The most important empirical issues should be set forth. The first relates to the importance of SSIs in the Sudan; thus section 10.4 exposes the magnitude, composition and characteristics of SSIs and their contribution to national income and employment.

A second issue centres on, first, the labour-intensity of SSIs and, second, the output generated by unit of capital by SSIs. Do SSIs, for example, possess a higher labour/capital ratio than large-scale industries? Then, given the output objective and the apparent relative scarcity of capital, do smaller firms use less capital to produce a given value of output than larger firms? These two points are discussed in section 10.5

A fifth, most important, issue is the source of financing to SSIs. Can SSIs have access to external finance or do they depend on internal finance? In other words,

is the finance available to SSIs adequate, and if not, what are the causes? Because of the importance of this SSIs financing issue, the next chapter is an empirical examination of the experience of FIBS in financing small crafts. For that purpose, primary data was obtained. In order to address the various issues raised here in this chapter, secondary data was collected from annual reports of banks and financial institutions, economic surveys of Ministry of Finance, the industrial surveys issued by Ministry of Industry, and other reports and leaflets issued by some academic as well as researches and professional centres concerned with industrial researches in general.

10.2 SSIs Financing: A Theoretical Background

Finance is required so that a firm may carry on its day-to-day operations and undertake investment projects. A review of the literature on small business financing in developed and developing economies identifies different opinions and views to the issue of small business financing.⁴¹ But there seems to be widespread agreement that the main problem for these firms is the inability to obtain sufficient funds to promote growth. This difficulty is not a recent phenomenon, it was highlighted as long as 1931 in the UK by the Macmillan Committee and has been subsequently discussed in the Radcliff Report (1959), the Bolton Report (1971) and the Wilson Report (1980). As Martin Binks summarised it, the problem is

'the smaller the firm, the larger the proportionate increase in the capital base required to respond to an increase in demand, but the lower its ability to command loan and equity finance', (Binks, M., 1979). This shortage of finance, or a finance gap, as a formidable constraint to smaller firms, has been identified by the Committee on Finance and Industry in 1931.

10.2.1 Finance gap

As mentioned above, the debate concerning the finance gap has a history going back to the Macmillan Report of 1931 in the UK. The report pointed to the existence of what has come to be known as the 'Macmillan Gap',

⁴¹ Throughout this chapter and the next one, the terms 'firm', 'business' and 'enterprise' are used interchangeably as collective terms.

'It has been presented to us that great difficulty is experienced by the smaller and medium-sized businesses in raising the capital which they from time to time require even when the security offered is perfectly sound. To provide adequate machinery for raising long-dated capital in amounts not sufficiently large for a public issue always presents difficulties.'

Thus the Macmillan gap was the lack of provision for small and medium-sized businesses seeking external finance. The Macmillan Committee proposed the setting up of a specialised institution concerning itself particularly with the financing of smaller commercial and industrial companies. However, operations and performance of such types of institutions suggested by this and other reports and which have been, in consequence, set up, will be examined later.

In 1959 the Radcliff Committee commented

'there is a danger, which it is socially as well as economically desirable to avoid, that the growth of small firms may be impeded because they lack some of the facilities open to large companies for obtaining capital', (Radcliff Committee Report, HMSO, Cmnd. 827, August 1959).

In 1961 Bates said

'despite some progress in the period, partly as a result of the recommendations of the Macmillan Committee, the financial problems of small firms are little near solution than they were thirty years ago', (Bates, J., 1961, p. 470).

Bates added that the finance gap is partly economic, in the sense that many firms are not credit-worthy by normal standards and partly institutional, in that the range of existing institutions is inadequate and the special institutions do not operate on a large enough scale.

Again in the UK, in 1971, the Economists Advisory Group (Bolton Committee) stated that

'we do not, however, believe that there is any single major gap or deficit that calls for radical action. If we may so style it, there is no 'Bolton gap' analogous to the 'Macmillan gap' to exist some years ago', (Economist Advisory Group, Part 1, Report No. 4, p. 68).

But the Bolton Committee pointed to an existence of what may be called as 'information gap' that small firms are less informed than larger ones about sources

of finance and they are less advised; lenders have less knowledge about the affairs of small firms than of large firms and are thus handicapped in their assessment of risk. The Committee added that the 'transaction costs' (of investigating and administering) loans tend to vary inversely with the size of a loan, so that for equal risk with a large firm, the small firm would have to pay a higher rate. The Bolton Report concluded that firms may fail to obtain finance either because they have not applied to the most appropriate source, or because they have done so and, nevertheless, been refused. Thus, to the Bolton Committee the small businesses were still disadvantaged in seeking external finance compared with larger firms.

There is another report in 1980, the Wilson Report, identifying an existence of finance gap for small firms, stating that the assistance provided to potential entrepreneurs by the capital market is limited. The Wilson Report finding is that

'bankers believe that lending to small firms is more risky than lending to large and that loss ratios are therefore likely to be higher. Moreover, banks are notably reluctant in supporting innovative developments', (Interim Report of the Committee, HMSO, Cmnd. 7503, March 1979).

The Wilson Report identified as well an 'information gap', saying that a persistent theme in the evidence received by the Committee is the alleged existence of the communications gap between small firms and financial institutions. Small firms may not know enough about the range of different forms of financial help and advice available to them. Small firms even after they have identified an appropriate source of finance may lack the skills necessary to prepare a persuasive case.

Small firms in other countries have similar difficulties. In the United States, a nationwide survey conducted by the Department of Commerce in 1934 disclosed that the long-term funds could not be obtained from any source by almost half of all small manufactures needing such credit. There was a shortage in the flow of long-term capital to small businesses. The issue was returned to in the late 1950's. The Federal Reserve Board of 1958 provided the basis for the Small Business Investment Act of 1958. The Reserve Board's Report was, however, by no means unanimous. The general conclusion was that there was

'some evidence in the background studies that there is an unfilled margin, perhaps a rather thin one, between the volume of funds available to small concerns in general, and to new firms in particular, and the volume that could be put to use without prohibitive risk.', (Federal Reserve Board Report, 1958).

Kaplan and Banner (1958), Garvin (1971) all claimed to have significant evidence of small business capital gap with respect to intermediate and long-term loans.

In Canada, the Industrial Development Bank was set up in 1944 to help fill a gap in the financial structure, closely resembling the 'Macmillan gap' which, it was argued, was unlikely to be filled by private institutions. Its function is to make term loans to industrial enterprises which, because of their small size, or a lack of a sufficiently long earning records, or complications in respect of the security they could offer, could not obtain term financing from other sources on reasonable terms and conditions, (Bates, J., 1961).

Gunter Kayser and Dieter Ibielski (1989) said that small and medium-size enterprises in West Germany suffer from a high debt to equity ratio (gearing ratio) which does limit their investments. For this reason, and because of their lack of easy access to capital markets, the German Government specifies financial aids to these firms. In Brazil, the government adopted a series of measures, the object of which is to strengthen the financial position of small firms. In 1965, the Brazilian National Development Bank created a special line for medium-and-long-term financing to small firms, (Barros, F. R., 1978).

There is a consensus among academicians and professionals in the Sudan that there is a shortage of finance to small firms, (National Economic Summit, 1986). But still there is no empirical work done on the identification and measurement of the financial difficulties and problems of small enterprises.

10.2.2 Why does finance gap exist for small firms?

Banks and other financial institutions employ normal commercial criteria and the less obviously creditworthy firms are unlikely to be helped. Banks are in most cases held back by an insistence on normal standards of creditworthiness based

on an assessment of the financial prospect of the applicant. For normal purposes such assessments are reasonable enough since most lending institutions have to take a prudent view; but part of the Macmillan gap arises from the existence of firms that cannot fulfil normal standards. Thus, finance gap arises for smaller firms as : (i) these firms may not have a good profit record; (ii) they may appear risky, or their plans may take a long period to mature; (iii) they may not be able to offer lenders the security they normally require; (iv) the unit costs involved in processing applications for small firms is relatively greater; (v) the owners of small firms may not always have the necessary financial expertise; (vi) they may not know enough about the range of different forms of financial help and advice available to them; (vii) they may lack the skills necessary to prepare a persuasive case; (viii) proprietors of small firms appear to fear loss of independence if they accept funds from outside sources; (ix) suppliers of fund do not always sufficiently understand the special needs of small firms and the constraints within which they operate and, (x) small firms are at relative disadvantage in influencing policy making and in making applications for selective aids.

However, views may differ on the reasons why a finance gap arises for small firms, but these are nearly the main causes of the gap. Mike Jarrett and Mike Wright (1982) argued that if the firm is newly established, it lacks a track record of success to encourage individuals and institutions to provide funds. The Wilson Report (1980) found that bankers believe that lending to small firms is more risky than lending to large and that loss ratios are therefore likely to be higher. The Report criticised banks as saying that

'their attitude towards risk, and ability to assess it, are said to make them unnecessarily restrictive in their lending policy, particularly towards new or rapidly expanding small firms', (Interim Report, HMSO, Cmnd. 7503 March 1979).

On the other hand, security is one of the main problems facing small firms in raising external finance. The shorter the track record of the firm, and the lower the value of its capital assets, the higher the ratio of concrete security to loan requirements. Thus, small firms feel the great burden of security requirement, (Binks, M., 1979).

In fact, there are voluminous writings on these causes of finance gap facing

smaller firms and hindering their growth, J. Bates (1961; 1982), Peter Johnson (1978), P. J. Hutchinson (1978), Graham Bannock (1981), William A. Brock and David S. Evans (1986). All these writers approached these reasons of the finance gap and its implications. Committee reports contain exposition of these constraints as well as recommendations to get rid of them.

However, in a country like the Sudan, small firms face not only the constraints mentioned above, but in addition they are faced with unfavourable economic conditions and rigidities characterising the Sudan economy, and an absence of clear-cut policies to support their case and enhance their position. There is neither a definition for what constitutes a small firm nor a policy for smaller businesses in the banking system.

10.2.3 Solving an identified finance gap

10.2.3.1 External source of finance

(i) Long-term credit

As mentioned earlier, opinions and evidence of a finance gap for small firms are conflicting. In both Britain and the United States financial facilities have been provided although at different times and in different ways.

The UK was the first to consider the problem in the Macmillan Report and the first to act, with the implementation of that Report's recommendation. The Macmillan Committee proposed the setting-up of a specialised institution concerning itself particularly with the financing of smaller commercial and industrial companies. The formation of the Industrial and Commercial Finance Corporation (ICFC) in 1945 was a fruit of the Macmillan Committee proposal. The ICFC was set up by the Bank of England and the clearing banks and was intended to supplement existing financial institutions. It is now part of the Finance for Industry (FFI), which is 15% owned by the Bank of England and 85% by the London and Scottish clearing banks. Thus the ICFC was created to provide medium-and-long-term finance for small and medium-sized firms.

The ICFC invested a total of £400 millions in small businesses over the period 1945-73. It was restructured in 1973. The total invested over the period 1973-79

was £248 million in both loan and share capital, (Interim Report, 1979). Loans are normally payable over periods of up to 20 years. Interest rates, which are determined by the cost of money to ICFC, are fixed for the period of the loan. On the other hand, equity stakes are normally sought as part of the financial package where the investment is thought to be particularly risky. ICFC also purchases equity through its associate Estate Duties Investment Trust (EDITH), and it seldom invests in totally new enterprises. It also provides financial advice and other services to its customers, and leasing and hire-purchase facilities and sale-and lease back of property.

In 1961, Technical Development Capital (TDC) was formed to provide finance for technologically innovative businesses. TDC was taken over in 1966 by the ICFC and becomes subsidiary under the wing of ICFC which provides it with larger resources of funds and staff.

There are other specialised institutions formed to do similar functions. For instance the National Research Development Corporation (NRDC) was set up in 1948 to provide finance for industry and trade specifically oriented to the exploitation of inventions and technological innovations where adequate finance is not available from other sources. The National Enterprise Board (NEB) was established in 1975 with the objective of promoting industrial efficiency. The Council for Small Businesses in Rural Areas (CoSIRA) was formed in 1968 to support employment in small firms in rural parts of England. There are also other government-funded institutions to support small firms, the Scottish Development Agency (SDA) and the Welsh Development Agency (WDA) are being assigned to do similar functions, both giving loan and equity in their respective countries.

As stated earlier, the Bolton Committee mentioned that there is an 'information gap' and 'advice gap' crippling small firms to obtain finance,

'we found a widespread belief that small firms were ignorant of the sources of capital, the appropriateness of various types of loans to their particular needs and the conditions that would be expected of them if they were to secure the finance they desire. We also found considerable disquiet at the quality of advice in these matters that firms received from their professional advisers. There may be what we might call an 'advice gap', (Economists Advisory Group: Part 1, Report No. 4, 1971).

Thus, Bolton Committee felt that smaller firms should not be put at a disadvantage compared with large firms. To remedy the disadvantage of the 'information gap' the establishment of Small Firms' Advisory Bureaux was recommended.

One of the most important British government moves in the direction of solving the problem of small firms in this regard has been the setting up of Small Firms Information Centres (SFICs). This is a direct result of the Bolton Committee's recommendations. The SFICs provide a range of advice including a series of booklets on most aspects of small firm management, a telephone information service and a counselling service which enables owners and managers of small firms to discuss their problems with other experienced businessmen.

However, shortcomings of the previous attempts at providing finance for small firms have been detected and suggestions are included in these reports to remedy them. Problems with the specialised equity and loan institutions that have been set up may be summarised as: (a) in relation to the needs of small firms, the amount of funds actually provided has been fairly small; (b) some of the institutions impose high minimum size cut-off points; (c) for those institutions not dealing exclusively with small firms, the disproportionately high cost of processing applications and the higher risk involved would lead them to prefer investment in larger projects; (d) many institutions appear to be slow at providing funds whilst there has also been some hesitancy among small firms to approach the institutions, (Jarrette M. and Wright M., 1982).

The Wilson Report recommended the establishment of a Loan Guarantee Scheme (LGS), which would remove the constraints imposed by security requirements which restrict bank lending to small firms. Under such a scheme, the government would underwrite loans provided by the financial institutions. The main issue is the amount of risk the clearing banks should have to bear.

The LGS was introduced in 1981. The government guaranteeing 80% of the loans to smaller firms. Loan periods may be from two to seven years, at the commercial rate of interest plus 3% per annum. The scheme as formulated was criticised as it appears to have a number of shortcomings: (a) the amount of money available is small; (b) the loan period is only a medium-term; (c) the interest rate is punitive instead of being subsidised, (Bates J. and Parkinson J.R., 1982; Jarrett

M. and Wright M., 1982). However, until the introduction of the LGS, Britain lagged markedly behind Canada, France, West Germany, Japan, Netherland and the United States, all of which made use of credit guarantee and subsidised loan and equity finance schemes for small firms. In France the length of the loan period can be up to twenty years, with a period of grace before interest payments.

The introduction of the Unlisted Security Market (USM) towards the end of 1980 was made partially in response to the recommendation of the Wilson Committee and partially in response to the general lack of venture capital that is provided for existing firms to expand. It was intended to fill a gap in the provision of venture capital for small firms on London stock exchange. By reducing the percentage of equity required to be in public hands, from 25% for a full listing to 10% on the USM, and by lowering the cost of entry, it was hoped that smaller firms would be able to raise external finance more easily than hitherto.

Another method of finance was initiated. Whilst the USM seems most appropriate for fast growing firms and LGS for riskier projects, finance for management buy-outs (MBO) is concerned with firms where the owners wish to sell. There are three main types of buy-outs schemes: (1) asset purchase, (2) holding company loan and (3) funding and share purchase. Typically, the financing takes the form of a combination of loan and equity funds, with usually the majority equity stake lying with the management.

In the USA Congress codified the concern for small business with the passage of the Small Business Act in 1953, which established the Small Business Administration (SBA). It directed the SBA to help small firms obtain government loans, government contracts and technical and managerial know-how. Congress strengthened this Act in 1958 by requiring government agencies to conduct a representative share of their business with small firms. It also passed the Small Business Act in 1958, which encouraged the creation of investment companies that could provide small businesses with venture capital, (Brock, W. A. and Evans, D. E., 1986).

The SBA was established as an independent federal agency to assist, counsel and champion the millions of American small businesses. The range of help provided is very wide and includes the actual provision of funds, both in the form of

loans and loan guarantee and in the form of equity through SBA licensing of Small Business Investment Companies (SBICs).

The SBA helps small businesses obtain loan finance in three forms: (i) by direct loan; (ii) by participation loans with private banks and (iii) by guaranteeing loans from private banks. The first type, direct loans, are only used as a last resort. SBA emphasizes maximum private lender participation in each loan. This policy has made it possible for SBA to provide funds to a much greater number of applicants than would be possible under a direct loan programme, (Hutchinson, P. J., 1982). When loans from private sources are not available on reasonable terms, SBA may guarantee up to 90% of a bank loan to a small firm. For the SBA guarantee the private bank pays SBA a percentage fee. The interest that the bank may then charge the small firm is limited by SBA regulations.

If a small firm cannot obtain a loan from a private bank on a participation basis with SBA and if, even with the offer of 90% guarantee, a loan is not forthcoming, the SBA may grant a direct loan. The firm must of course produce a good case for the money but even then funds may not be available due to the Federal Fiscal restraints. The loans are granted for periods up to 20 years for the acquisition of land and building, up to 6 years for acquiring working capital, and otherwise up to 10 years. The interest rate on SBA's portion of participation loans as well as its direct loans are regulated by a statutory formulae relating to the cost of money to the government. A special feature of SBA is its provision of financial opportunities for disadvantaged groups like loans for the handicapped. Congress strengthened the role of SBA as a representative for small businesses within the government. In 1976, Congress established the Office of Advocacy at SBA. This office was directed to measure the direct costs and other effects of government regulations on small businesses and make legislative and non-legislative proposals for eliminating excessive or necessary regulations of small businesses.

On the other hand SBICs provide both equity capital and long-term loans to small firms, they also provide management assistance to the firms they finance. Without special SBA approval the total funds loaned to, or invested in equity securities of a particular small business, a single SBIC may not exceed 20% of the paid-in capital and surplus of the SBIC. The most important feature of the SBICs

is the gearing they are able to exploit through SBA guarantee. An SBIC may request SBA to lend, or to guarantee 100% of the loans from private institutions to the SBICs up to an amount of 300% of its private capital. A private investor in an SBIC is granted concession on personal tax. Moreover, as far as corporation tax is concerned, SBICs are allowed a deduction of 100% of dividends received from a taxable domestic corporation rather than the 85% allowed to most corporate tax payers.

Thus far, these are almost the main sources of external long-term finance, both in equity and loan form, to small firms. The dominant suppliers of external loan finance for small firms are, of course, banks. On the other hand, special institutions provide equity capital.

(ii) Short-term credit

In order to fill the finance gap, small firms, like other companies, need short-term finance. If small businesses have problems in this respect they may not survive into the long term. The argument is that small firms need not only long-term capital for expansion, they need also financial resources for working capital. The four main sources of short-term finance are: trade capital, factoring and bank credit and hire-purchase and leasing.

Trade credit works in two directions: the firm gives credit to its customers (debtors) and it itself receives credit from suppliers (creditors). Two motives exist for extending trade credit, the 'transaction' motive and the 'financing' motive. The transaction motive produces a certain level of trade credit which exists merely as a consequence of doing business. The financing motive relates to that proportion of trade credit that responds to economic stimuli, especially monetary policy (i.e. the relative difficulty in borrowing money and the level of rate of interest).

Factoring and bank credits: one of the ways in which a small firm can reduce its trade debtors is by resorting to factoring. The principle is that the firm sells its trade debts to a factor; the factor then takes over the responsibility for collection of the debt. By instantly providing up to 80% of invoice value, the firm has the advantage of liberating the cash tied up in debtors. Liquidity is thus increased, and the dependence on outside resources is reduced. The bank's role here reflects its traditional one as a provider of short-term funds.

Hire-purchase and leasing: hire-purchase is rarely used by large companies, but it is frequently a feature of small firms' purchases of plant and machinery. It is particularly used by small, rapidly growing firms who may find it difficult to arrange a bank loan.

10.2.3.2 Internal source of finance

As seen above, small firms face constraints in raising funds from external sources especially equity capital. The younger firms are not within reach of equity finance as provided by the over the counter (OTC) markets, (Wilson Committee Report, Interim Report, 1979). They are therefore dependent upon injections of equity by individuals concerned with the firm (or their relatives), or retained profits. As for retained profits, small firms who plan to remain competitive are unable realize very high levels of profitability.

However, the proprietor's equity is normally used as funding start-up capital. The Wilson Committee found that individuals setting up business for the first time fall into one of three categories. First, there are those starting completely from scratch, with the proprietors having no experience in, or connection with existing enterprises. Secondly, there are ex-employees of existing firms starting up in similar or related areas. Finally, there are those who take over existing businesses with the intention of developing them along different lines.

But in almost every case the main initial source of capital will be equity subscribed by the proprietor himself, or by his family. The number of outside investors prepared to take equity stakes (especially for start-up capital) in small new businesses is limited.

Proprietor's own equity is also the most appropriate source of venture capital for an innovation. Banks are notably reluctant in supporting innovative developments, developments which sometimes are in the context of major changes of process or product and does not always necessarily involve new technology. Small firms feel the difficulties particularly acutely more than large firms because of their disadvantageous position in the capital market. So they depend on the proprietor's equity.

- Summary

Writers though expressed conflicting views, identified an existence of 'finance gap' and 'information and advice gaps' for small firms. In the UK, USA as in other countries efforts were launched to bridge the gaps by establishing the specialised financial institutions and by encouraging the banks to provide more funds to small businesses. Deficiencies in financing small firms were pointed out by writers and notably by committees formed by governments, especially in the UK. The main issues are: the subversion of limited liability by requirements for 'excessive' security and the tendency for banks to assess firms for their break-up value rather than as going concerns. In short, criticism is that banks lack flexibility and are reluctant to take risks.

However, the potential for bank lending to small firms is a profitable opportunity to be seized, and banks must face the real obstacles to this endeavour which have more to do with banks' organisation and general attitudes than with small firms themselves. Generally, financial institutions operate as if their small business customers are the same as private individuals whereas their needs are, in fact, different.

Graham Bannock argues that

'sustained economic growth in the economy as a whole will not be resumed until there is a massive shift in resources towards small firms, (Bannock, G., 1981).

The small businesses sector could be a net lender to the financial market. If the sector grows – and banks help bridging the finance gap – these advantages could become even more attractive to banks which have suffered in other areas from competition from each other. Certainly, competition among the banks for small business customers seems less acute than it is for other categories of customers. Exploiting fully the opportunities available in the small firms sector will require more flexibility in lending, and fundamental changes in attitudes and organisation.

If, however, a finance gap, information gap and the advice gap have all been identified for small firms in developed countries like Britain, then by all means small firms in the Sudan face even a much more worse situation. The finance gap facing small firms in the Sudan will be examined in section 10.5 of this chapter and

in the next chapter. The gap will be examined in its economic dimension, i.e. as many small firms are not creditworthy by normal standard, and in its institutional dimension, i.e. the range of existing institutions is inadequate and the specialised institutions do not operate on a large enough scale.

10.3 SSIs Development Within The Industrialisation Processes

In the long run, an establishment of a significant number of small businesses in a country, especially in rural areas, will widen the base of ownership of industrial enterprises. It has been observed that, irrespective of the level of development or degree of industrialisation of any country, the small firm is substantially important to its progress. Continued experience indicates that this type of a firm has its own, exclusive characteristics indispensable in both developed and developing countries. In the developed world, economists have shown concern for small firms and their problems (especially financial constraints) because the restriction of growth so produced can have serious implications for employment, innovation, the ability to compete with foreign firms, the ability to counteract the undesirable effect of increasing industrial concentration and so on.

This section will give a historical and institutional policy review as related to the small industry development in the Sudan so as to grip policy constraints that might have been affecting this sector.

At the outset it is important to mention here that a definition of what constitutes a small firm is still lacking. Small firms are a very heterogeneous sector, and it is even difficult to agree on what is a small firm and how big is the small firms sector. As Peter Johnson put it

'inevitably, what constitutes a small firm is a matter of judgement', (Johnson, P., 1978)

The method usually practised is that of characterising a firm's size by the number of employees and/or by its turnover. In the UK, in terms of reference given to Bolton Committee, it was suggested that 200 employees might be regarded as the upper size limit for such a firm. This definition was revised by Wilson Committee which depended very much on a definition in terms of turnover. In the USA, the definition of a small firm for SBA purposes varies and depends on the type of help sought, the nature of the business and the particular industry in which the small

firm operates. The definition of 'small' in the USA context does in fact include many firms which would be regarded as medium or even large in other countries.

In the Sudan there is no specific definition for a small firm, but some institutions used to classify SSIs according to total investments and the number of employees. For instance, the Ministry of Industry, following the Arab Industrial Development Organisation (AIDO), defines a small firm as that employing 24 labourers or less, and whose fixed assets investments is not more than LS. 500,000. The Industrial Research Consultancy Institute defines a firm as small if it employs between 10 to 50 labourers and invests not less than LS. 40,000 and not more than LS. 200,000. The Sudanese Rural Development Company defines small firms on financial basis, and a firm is considered small if its investment is US\$ 25,000. However, all investment acts have not decided on what constitutes SSIs in Sudan. Because of the difficulty in obtaining data concerning investments in smaller firms, and due to the high inflation rates in Sudan and the subsequent devaluations of the national currency, a small firm is defined here to include firms employing 50 labourers or less. It seems an appropriate definition in the case of the Sudan as it was suggested by UNIDO (September 1985) and by the ILO. It seems also suitable as the economy is backward, especially in respect to industry.

10.3.1 Industrial Sector Growth

Due to an increase in the number of industrial enterprises, and an increase in industrial investments during the 1960s, the contribution of the industrial sector rose from 1% in 1956 to 6.7% in 1960 and to 15% in 1973. This contribution then declined to 8.3% in 1974/75, 6.8% in 1981 and to 6.5% in 1984/85 (Table 10.1). This decrease was attributed to the problems facing Sudanese economy in general and the industrial sector in particular.

Six distinct periods of Sudanese industrial development may be distinguished:

- 1) The pre-independence period until 1956, with cottage industries and colonial-type processing of exported primary products;
- 2) 1956-1960, with indirect public intervention and the introduction of modern manufacturing;

Table 10.1: Structure of Production (GDP) (%) 1978-1988

	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88
Agriculture	31.5	34.1	32.0	32.6	33.1	30.9	42.3	37.4	40.0	40.7	39.9
Industry	7.5	8.7	6.8	6.9	6.8	7.0	5.8	6.5	6.9	7.0	7.6
Mining	0.06	0.1	0.1	0.1	0.1	0.1	0.07	0.1	0.1	0.11	0.11
Water and electricity	1.3	1.4	1.7	1.7	1.7	1.8	1.4	1.9	2.0	1.9	2.0
Construction	4.1	3.8	3.9	4.0	4.1	4.4	5.4	5.8	5.12	4.9	5.0
Transport and communication	7.9	11.2	8.6	9.0	9.4	8.6	5.4	5.8	5.12	4.9	5.0
Trade and real estate	19.3	19.7	19.2	20.1	19.7	19.9	13	13.8	13.7	14.3	14.2
Other services	22.7	21.0	18.1	11.3	16.6	10.0	21.7	23.7	21.8	20.2	20.6

Source: Ministry of Finance, Economic Surveys, various issues

3) 1960-1969, with direct public intervention in industrialisation parallel to private industrial investments;

4) 1969-1973, with nationalisation and confiscation of private industries in 1970, followed by denationalisation in 1971;

5) 1973-1977/78, with huge agro-industrial investments mainly by the public sector;

6) From 1977/78 onwards, with greater economic pressures affecting industry.

Development of SSIs in the Sudan was affected adversely by these policies throughout these periods. However, objectives, strategies and instruments used have been changing considerably over time.

Concerning the first period, during the early period of colonisation, cottage industries prevailed and some products based on wood and cotton, could even be sold on foreign markets. The Sennar Dam built in 1925 made large-scale cotton cultivation in the Gazera Scheme possible. This led to the first stage of manufacturing as represented by cotton-ginning factories. The expansion of this industry encouraged the development of edible oil industries based on cotton seeds. However, the colonial import policy had negative consequences on the growth of the cottage industries (Hansohm D. and Wohlmuth K., 1987). Moreover, colonial interventions

affected negatively investments in the private industrial sector, especially in the small industry sector. Only oil-seed pressing industries were able to develop to some extent during that period, because of the widespread oil extraction activity taking place at the household level. Some import-substitution took place during the World War II. These industries were induced by supply bottleneck, but they were unable to survive after the war. Some SSIs by non-indigenous Sudanese private investors took place particularly in the spheres of confectionary, vegetable oils, soft drinks, soap, perfume and building materials.

The second period (1956-60) may be regarded as a period of indirect public intervention. Private investment was considered the main vehicle of industrialisation. The idea was to move quickly from import substitution of consumer goods to import substitution of intermediate and capital goods. The 'Approved Enterprises (Concessions) Act(1956) was an important step to promote private investments in the Sudan, but it did by its implicit policy prescriptions discriminate against SSIs. In this period, the State invested in large-scale agricultural and infrastructural projects, whereas the private sector concentrated on industry and housing. However, some structural change of industry towards textiles, shoes, paper products and chemical products took place. Thus, the second period may be considered the starting point of modern manufacturing in the Sudan. The neglect of rural development prevented any development of SSIs; in urban areas no support was given to SSIs and crafts.

The third period (1960-69) was crucial to the Sudanese industrialisation. Direct public intervention emerged. Influential was the 'Ten-year Plan of Economic and Social Development, 1961/62-1970/71'. It was during this period that the Industrial Bank of Sudan was established, in 1961, to give additional assistance to private industry. The nine public factories built up in the spheres of agro-industries did not upset the leading position of the private sector. However, the basic constraints to broader industrial development (the small market size, neglect of agricultural development and of rural industry) were not removed during this period by general and industrial policy measures. The low performance of industrial policies led to 'The Organisation and Promotion of Industrial Investment Act, 1967', stressing the role of private entrepreneur (Affan, B. O., 1985), but not improving the position of small and rural industries.

In the fourth period (1969-73), nationalisation and confiscation of private industries, including foreign capital, took place, but in 1971 the policy was reversed. The long-term consequences of these policies for Sudan's industrial development were important. In order to restore credibility and to attract foreign investors, even more favourable investment concessions were granted, 'The Development and Encouragement of Industrial Investment Act, 1972' was a move in this direction. In spite of these incentives, no improvement was achieved. Instead, these concessions distorted the structure of industry.

The fifth period (1973-77/78) was marked by intensive direct public intervention in industry. The intention was to expand modern agriculture and agro-industries rapidly. Various forms of public sector capital participation in industry were used, as well as institutional instruments (establishing, for instance, the Sudanese Development Corporation).

The government moved further towards the support of capital-intensive and import-intensive projects, mainly in the sugar and textile industries. The sharp increase of the capital/labour ratio in this period indicates not only the bias towards capital-intensive technologies, but also the increasing extent of excess capacities (Affan, B. O., 1985). This public policy attitude was typified in the US\$ 1 billion Kenana Sugar Project, (Wohlmuth, K., 1983). The large-scale bias of Sudan's industrialisation in this period drained all the *scarce* available resources from alternative uses.

The final period (since 1978) is also a period of industrial decline. The great number of public sector investment projects led to overspending, and pressure on both infrastructure and human skills. There was no industrial development planning to the effect of maximising linkages with other sectors, (Wohlmuth K. and Hansohm D., 1984). The absence of change to Sudan's productive system and to the income distribution system both resulted in a stagnating industrial sector.

The fact that since 1977/78 all the major branches of manufacturing industries have been in decline may therefore be attributed not only to austerity policies, but is basically the result of the inappropriateness of industrial policies to remove basic constraints. Despite the heavy agro-industrial investments in the 1970's, there is

virtually no agricultural machinery industry to support productivity increases in agriculture (Bedri, M. A., 1979).

The six periods show, (i) the increasing role of the public sector, and (ii) that the whole of industrial policy in the Sudan is not favourable for the internal growth of small enterprises. The government launched new measures in October 1989 to encourage investment in SSIs, especially in rural areas, (see Chapter VIII, section 8.5.4).

10.3.2 Overall Performance of SSIs

This section provides a profile of the magnitude, composition, regional distribution and contribution of the SSIs to national income and employment. Such an overview can usefully serve to provide a foundation for understanding the role played by SSIs in the Sudan. It is important to mention here that statistical records concerning SSIs are very deficient. There is obviously a limited coverage to SSIs outside urban areas.

10.3.2.1 Magnitude, composition and regional distribution

Table 10.2 reveals the total number of industrial enterprises to be 6759. Small enterprises (50 employees or fewer) comprises 95%, medium-size enterprises (50-100 employees) represents 3% and large-scale enterprises (above 100 employees) 2% of all industrial firms. It is also clear that the food industry is the principal industry among the different categories of industries.

**Table 10.2: Employment in Manufacturing Enterprises
by Size of Enterprise**

Number of employees	Classification	Number of enterprises	Percent
1-50	Small-size	6543	96.8
51-100	Medium-size	79	1.2
Above 100	Large-size	137	2.0

Source: Ministry of Industry, Industrial Survey, 1984/85.

Almost all small enterprises are privately owned, whereas 60% of large-scale industrial firms are owned by the public sector and 40% by the private sector. This situation came about because large-scale industries need huge investments which are unavailable to small investors, and are therefore undertaken by the State. In the case of SSIs, the amount of investment needed is relatively small, and the type of technology used is simple, thus, individuals are encouraged to establish small firms.

Regional distribution of SSIs shows that more than 50% are located in Khartoum area and the Central Region. The less developed regions of Darfor and the South have the minimum of small firms located there, 6.3% and 0.2% respectively. The other regions have almost equal numbers of small firms (Table 10.3). The concentration of these industries in Khartoum and the Central Region is for a number of reasons: (i) the relatively adequate availability of infrastructure such as transport and electricity, (ii) easy access to raw materials, and (iii) proximity to a potential market for the industrial products in the urban areas and Central Sudan due to the relatively high standard of living. Moreover, Table 10.3 reveals that all categories of SSIs are also located in Khartoum and the Central Region whereas the less developed regions lack most of these industries, especially textiles, weaving, wood products and basic metal industries.

10.3.2.2 Contribution to national income and employment

Relative to the great number of SSIs (95%) compared with the large-scale industries (LSIs), their contribution to employment and national income remains small. In terms of employment SSIs constitute 30.4% of industrial labour. With regard to the national income, 38.7% of the industrial component of the GDP is from SSIs. On the other hand, although LSIs (employing more than 100 labourers) represent only 2% of the number of industrial firms, they absorb 65.8% of industrial labour and 56% of the industrial component of the GDP. Medium-size industries (employing between 51 and 100 labourers) which represent 1.2% of the number of industrial firms, constitute 3.8% of the labour force in the industrial sector and 5.4% of the industrial component of the GDP (Table 10.4).

The significant share of LSIs compared to small industries could be attributed

Table 10.3: Regional Distribution of SSIs by Categories of Activities

	Food, tobacco and beverage	Textile, weaving and leather	Wood products and furniture	Paper products and printing	Chemical products	Metals industry	Basic metals industry	Fabricated metals and machinery	Total
Khartoum	1048	67	118	69	61	41	4	374	1782
	(20)*	(84.8)	(62.4)	(79)	(77)	(50)	(40)	(44)	(27)
Central Region	1522	9	43	7	5	29	5	170	1790
	(29)	(11.4)	(22.7)	(8)	(7)	(36)	(50)	(20)	(27)
Northern Region	841	-	12	-	-	2	-	68	923
	(16)		6			2.5		8	14
Kordufan	813	-	-	3	4	5	-	67	892
	(15.6)			(4)	(6)	(6.5)		(8)	(13)
Eastern Region	589	-	16	6	3	4	1	129	748
	(11.4)		(8.9)	(7)	(4)	(5)	(10)	(15)	(11)
Darfor	359	-	-	2	4	-	-	36	401
	(7)			(2)	(6)			(4)	(6)
Southern Region	3	3	-	-	-	-	-	7	13
	(1)	(3.8)						(1)	(2)
Total	5175	79	189	87	77	81	10	851	6549

* Percentage share

Source: Small-Scale Industries Survey, 1989

Table 10.4: Contribution of SSIs to GDP and Employment

	Number of firms (%)	Gross output (LS 000's)	%	Number of employees	%
Small firms	96.8	591.2	38.5	44014	30.4
Medium firms	1.2	82.8	5.4	5432	4.0
Large firms	2.0	862.2	56.1	95056	65.6
Total	100	1536.2	100	144502	100

Source: Ministry of Industry, 1989.

to the large size of investments. Of industrial investments, 77% go into LSIs and only 16% into SSIs. Thus, the considerable contribution of LSIs in employment and national income does not imply that these industries are more efficient than SSIs. Large firms records with regard to employment and output exceeded that of SSIs because the government invested in the industrial sector and it encouraged large-scale investments by granting concessions and tax exemptions.

The effective and efficient use of resources is important for the Sudanese economy as it faces economic and financial constraints. The economy lacks capital, savings and institutionalised credits for development, a developed infrastructure and a skilled labour. All these urge for an appropriate industrial strategy fitting the situation of the economy. In this respect, SSIs are important. An examination of resource utilisation by SSIs and LSIs would show the former to be more efficient than the latter. LSIs appear to be heavily capital-intensive and grossly unproductive. To provide evidence for this, three criteria are used: (a) the amount of investment needed to create a new job in each industry, (b) the value added, and (c) the investment/output ratio in both large and small industries. These criteria use an important element, capital, which is scarce in developing countries to be used in industry. Therefore, if the cost needed to create a new job is lower in the case of smaller firms, and if the value added and the output per unit of investment are higher than that of larger firms, then the SSIs sector could be more potential for development. This assumed potentiality becomes significant if it is known that LDCs lack the capital and the infrastructure to develop industry.

10.3.2.3 Investment and labour

The average investment in building and machinery was found to be LS. 26000 in small enterprises and LS. 6 million in LSIs (Table 10.5). Therefore, LSIs are more 'capital-intensive' than SSIs. Moreover, compared to LSIs, SSIs need half of the investment to create a job which costs LS. 9,000 in LSIs, (Sen A. R., 1985). This characteristic encourages investment in SSIs in general and in the case of Sudan in particular, for Sudan lacks capital for industrial development, has a work force which is redundant and has raw materials available. By absorbing this labour force, SSIs could help to solve the problem of unemployment and thereby improve the standard of living of the poor.

10.3.2.4 The Value added

The value added is an indicator to the performance of a firm. It gives the value of the product less costs of factor inputs (excluding wages and salaries). Theoretically, the value added of LSIs is assumed to be bigger than the value added of SSIs, as the investment, and hence output, is larger and is expected to contribute more. However, when the value added for SSIs is compared with the estimate of the value added of LSIs, the small enterprises are revealed to contribute more, approximately 51.7% of the entire industrial sector's value added (Table 10.5). In addition, the value added per unit of labour was found to be LS. 9300 in SSIs compared to LS. 2600 in LSIs. A shrinking 'value added' of large enterprises in the Sudan is due to two factors: (i) these industrial concerns are State-owned and suffer from sluggish administrative procedures and a heavy bureaucracy, and (ii) these industries depend on imported raw materials which require foreign currency to be obtained. SSIs in the Sudan import a much smaller share of their material inputs than do their large-scale counterparts. Thus, these smaller industries require less foreign exchange for material inputs per unit of output than do their large-scale counterparts, a distinctive advantage for SSIs as foreign exchange is scarce in the Sudan.

10.3.2.5 Investment/output ratio

The Investment/output ratio is an approximate measure of return on invested capital. Table 10.5 reveals that an investment of one 'unit' of capital investment

gives more than two and a half 'units' of output in SSIs, whereas one 'unit' of capital produces one 'unit' of output in LSIs. Thus, it is possible to conclude that, in terms of cost of creating new jobs, on the criteria of the value added and the investment/output ratio, the performance of SSIs exceeds that of LSIs.

**Table 10.5: SSIs: Investment, Output and Value Added
(LS. 000s)**

	Small firms	Medium firms	Large firms
Gross output	591.2	82.8	862.2
Output/worker	13.4	15.1	9.1
Investment	215.2	36.6	824.8
Investment : worker	4.9	6.8	8.7
Investment /output	1:2.7	1:2.3	1:1
Value added	288	20.7	248.7
%	51.6	3.7	44.7
Value added/worker	6.5	3.8	2.6
Average investment*	26.6	464.4	6021

* Fixed capital

Source: Ministry of Industry, 1987.

SSIs appear to need less capital compared with LSIs, and are characterised by low cost to create new jobs, high 'value added' and output/capital ratio. The Sudanese economy is experiencing a low saving ratio on the part of investors, inadequate capital for investment and inadequate infrastructure and low technical levels. These and other factors give prominence to SSIs. The time is ripe for these industries to be developed and for government to turn its attention to them and solve their problems. Of particular importance are the financial constraints facing SSIs. This issue is discussed in the next section.

10.4 SSIs and Sources of Finance

A detailed examination of the matter of finance to SSIs will be in the next chapter, evaluating the empirical experience of FIBS with small handicrafts. The

main objective of this section is to determine the role of the Sudanese and foreign, commercial and development financial institutions in servicing the financial requirements of smaller businesses, and to assess the volume and type of credit extended to SSIs. Investigating financial facilities available to SSIs will reveal whether a 'finance gap' exists for smaller firms in the Sudan. This gap will be examined, as mentioned above in section 10.2, in its economic dimension, i.e. as many smaller firms are not creditworthy by normal standards, and in its institutional dimension, i.e. the range of existing institutions is inadequate and the specialised institutions do not operate on a wide enough scale. Thus, the ultimate objective here is to see, if there is a finance gap, whether financial institutions are, at least partially, responsible for it.

In considering the financial position of small businesses in the UK, the Bolton Committee (1971) and the Wilson Committee (1979) investigated the working of the banking system and in particular the effect of the monetary policies on the operations of banks who were regarded as the dominant suppliers of external loan finance for small businesses. The efficiency of the capital markets was measured in the UK and other developed and developing countries by the long-term debt and equity finance. In 1955, a study by the Board of Governors of the Federal Reserve System of the USA measured the financing problem of smaller firms by the period of credit contraction, the availability of credit to smaller firms and the policies of financial institutions towards small businesses. However, the adequacy of financial institutions with regard to the financing of small firms will be measured here by the amount of credit available to small firms compared with the financial ability of these institutions, and by the conditions of financing, taking into consideration the credit policies of the central bank, and other factors affecting credit extension.

The existing sources of finance to industry in general and small firms in particular are, (i) public and private commercial banks, (ii) public development financial institutions which are supported largely by government such as the Sudanese Industrial Bank (SIB) and the Sudanese Development Corporation (SDC), and the private and joint-venture development agencies such as the Islāmic Investment Company (SUDAN) (IICS).

10.4.1 Commercial Banks

The financial system in the Sudan is entirely regulated and managed by the government. The Central Bank exercises a quantitative monetary control, primarily by specifying credit ceilings of the commercial banks, as well as qualitative control of the allocation of banks' financial resources. In addition, the Central Bank has the financing power to approve any loan or advance exceeding certain level (LS 300,000 in 1988). In controlling the supply of money, the Central Bank prescribes the liquidity ratios of commercial banks and requires obligatory deposits with the commercial banks.⁴² In short, institutional financing is highly influenced by government policies (especially monetary and credit policies) and those of foreign lenders.

In the Sudan, there is neither a definition for what constitutes small business, nor a policy for small businesses in the banking system. There is no clear-cut policy regarding small business. The issue is dealt with casually, while the bank is trying to conform to the directives of the Central Bank, (Ahmed, S. A., 1988). However, no classification as to the size of the business is considered in the process. Therefore, commercial banks were criticised by small firms' owners for their lack of response to small business financing. Thus, there is an indication of a small business 'policy gap' in the banking system in Sudan. Empirical investigation by the author uncovered that the share of SSIs in total industrial financing by banks was only 1%. Moreover, bank managers indicated that 44% of the credit given was in the form of working capital, only 6% in fixed capital and 50% in both working and fixed investments; and 94% of the loans were of medium and short-term nature.

In investigating the causes of this deficiency of banks in financing small businesses, three factors are under consideration: (i) the monetary and credit policies of the Central Bank, (ii) the financial ability of these banks and (iii) the behaviour of bankers towards smaller firms (this point will be elaborated more in the next chapter).

Regarding the first factor, the credit squeeze policy imposed by the Central Bank and the austerity policies adopted by the government are, partly, responsible

⁴² For detailed exposition of these policies and their implications see Chapter VI (section 6.4), Chapter VII (section 7.7) and Chapter VIII (sections 8.5).

for the difficulties smaller firms have faced in raising institutional finance (see Chapter VIII). Under the ceiling system, banks tended to extend credits to small enterprises only to the extent that funds were not required by large firms. Small business bears the brunt of the restrictive monetary policy.

Considering the second factor, the commercial banks' financial ability enables them to finance small firms. Referring back to Table 7.17, it is obvious that banks have a large portion of their resources unutilised. Excess lending capacity of banks (depending on deposits only and not including capital) increased from 28% in 1980 to 52% in 1983 and 58% in 1988. The existence of a small business financing gap, in conjunction with the large amount of unutilised lending capacity provides evidence that banks contributed to this gap.

Third, empirical work provides evidence that commercial banks in the Sudan were mainly concerned with trade financing. Table 8.3 shows that short-term loans dominated the advances made by the commercial banks (64% in 1988). This finding is a reflection of the lack of long-term financing offered by banking system in general (see section 8.4), despite the credit policies (1985; 1986) directing banks to increase the share of medium and long-term financing. On the other hand, there is no formal definition of smaller firms. Therefore, regarding industrial financing, it is difficult to determine quantitatively the contribution of commercial banks in financing smaller businesses. Bank managers enumerated a number of reasons for giving a high priority to large firms rather than to small and newly established enterprises that: (i) under the credit squeeze policy, a bank has to channel its use of resources into profitable and well secured investments; (ii) large enterprises are more able to provide guarantee and security to a bank and (iii) banks are more eager to secure their profits rather than to concern themselves future prospect of the small businesses. Thus, the attitude of bankers is not favouring financing small firms, and there is a 'Sudanese' Macmillan gap in its economic dimension.

10.4.2 The Sudanese Industrial Bank (SIB)

Development banks were perceived by academics and professionals as instruments for achieving rapid industrialisation. The theoretical foundations of this type of development financial institutions are industrial development and the provision of long-perspective finance at a reasonable terms and costs to firms which

are unable to maintain their lending relations with commercial banks. An important question in this regard concerns the extent to which SIB established a system of finance for industry and the way in which this differed from commercial banking practices.

The SIB was established in 1961 as a development financial institution with an authorised capital of LS. 5 million,

'Given the low level of savings, scarcity of foreign exchange, and investors' reluctance to indulge in industry, the need for a specialised industrial financing institution seemed imperative. Sudan's commercial banks' loans to industry have been characterised by their short-term nature. Private Sudanese investors were sceptical towards investment in relatively new field industry', (SIB Report, 1980).

The 1961 legislation confined the bank to the financing of projects in the manufacturing sector only, regardless of the size of industry.

10.4.2.1 SIB: total funding operations

Table 10.6 analyses the bank's operations since its inception in 1962, and reflects the effect of these operations on investment and financing of industry. During the period 1962-87, the bank approved 294 loans to establish new projects and 88 supplementary loans for existing projects. The total bank contribution in these projects was LS. 36.3 million (88%), in the form of loans; LS. 3.5 million in equity form (8%) and LS. 1.6 million as guarantee (4%). Thus, the total bank contribution during this period (25 years) amounted to LS. 41.4 million, as part of the total investment of LS. 406.6 million, i.e. the bank contribution represented 10% of the total investments created by the financial and assisted firms. In fact up to 1986, the cumulative percentage contribution of the bank to total investment was 55%, but there was big increase in total industrial financing in 1987. Moreover, it is noticeable that loan finance was dominant whereas equity finance was meagre.

The number of industrial firms receiving loans and financial facilities from SIB was 351, (SIB Report, 1987). This shows the low level of financial contribution of SIB to industry. According to the 1984/85 industrial survey, the number of manufacturing firms registered in the Sudan was 7036. This indicates that only 5% of manufacturing firms succeeded in obtaining finance from SIB.

Table 10.6: SIB: Analysis of Operations (1962-87)
(LS. 000s)

	Number of loans		SIB contribution			Total	Percentage contribution	
	Original	Supplementary	Loans	Equity	Guarantee		SIB	Investors
1962	5	-	67.7	-	-	67.7	51.5	48.5
1963	14	3	397.8	-	-	397.8	67.6	32.4
1964	13	3	242.3	-	-	242.3	48.1	51.9
1965	8	-	136.4	-	-	136.4	16.2	83.8
1966	15	4	350.6	438.4	193	982	72.7	27.3
1967	14	3	159.6	-	-	159.6	59.5	40.5
1968	11	4	234.1	-	52.8	286.9	54.7	45.3
1969	1	-	4	-	-	4	66.6	33.4
1970	3	3	72.4	-	270	342.4	65	35
1971	16	3	272.5	-	445.1	717.6	67.4	32.6
1972	9	3	293.6	-	77	370.6	71.1	28.9
1973	11	4	1507.5	-	423	1930.5	46.5	53.5
1974	7	5	316.1	-	88	404.1	60.3	39.7
1975	5	5	1271.4	-	-	1271.4	54.8	45.2
1976	9	3	1747	138	-	1885	60.3	39.7
1977	6	6	552.8	-	-	552.8	60.3	39.7
1978	16	1	817.7	-	-	817.7	55.1	44.9
1979	14	6	714.7	-	-	714.7	63.8	36.2
1980	13	8	1733.8	-	-	1733.8	47	53
1981	15	8	1172.2	-	-	1172.2	52.5	47.5
1982	23	6	1524.1	-	-	1524.1	42.3	57.7
1983	13	3	1795	-	-	1795	52.6	47.4
1984	18	3	4160.6	900	-	5060.6	55.3	44.7
1985	-	-	-	-	-	-	-	-
1986	6	1	2249.1	-	-	2249.1	55.6	44.4
1987	29	3	14467.5	2000	-	16467.5	45.5	54.5
Total	294	88	36260.5	3476.1	1549	41285.5	36.8	63.2

Source: Sudanese Industrial Bank, Annual Report, 1987.

Unlike commercial banks, the SIB does not raise revenue from private deposits. It relies mainly on aid from the government in equity form, representing 66% of the total resources in 1987, and aid and loans from foreign agencies with an average of 34%. Thus, the bank's resources are meagre and it depends on Ministry of Finance, an absolute owner of the bank.

However, like commercial banks, SIB is experiencing unutilised loan capacity. This unutilised lending capacity was 29% in 1986 and 37% in 1987. An existence of such excess capacity with SIB is more disturbing than the situation at the commercial banks. Here again, the existence of a small business finance gap, in conjunction with the unutilised capacity of SIB is an indication of a small business 'policy gap'.

10.4.2.2 Financing SSIs

More important is the role of SIB in financing SSIs. Table 10.7 reveals that applications to SIB for credit increased from 52 in 1975 to 82 in 1982 and 111 in 1987.

Regarding investment, the bank's contribution in financing SSIs was 56% of total investments in these industries in 1975, and increased to 64% in 1980, then declined in 1983, to 49%. The share of SSIs in finance granted by SIB to all industrial firms increased from 12% in 1975 to 80% in 1979, 96% in 1980, shrank to 64% in 1982, 19% in 1983 and rose again to 88% in 1987 (Table 10.7).

However, the role of SIB in financing industry in general and SSIs in particular is still limited as:

(i) The strict credit policy imposed by the Central Bank on commercial banks had an indirect impact on the operations and performance of SIB. The policy affected the productivity of existing units funded by the bank and in consequence affected the level of collection of outstanding loans.

(ii) Monitoring and follow-up of executed operations is still lacking. The bank has little up-to-date information about the industrial units given credits.

(iii) The financial position of SIB is weak, and it is not allowed to borrow

from the banking system. Up to 1987, the paid-up capital is only LS. 24.4 million. This situation prompted the bank to concentrate on short-term finance which constituted 45% of the total finance by the bank in 1987 (SIB Annual Report, 1987).

Table 10.7: SIB: Credits to SSIs (LS. 000s)

	Noumber of applications	Approved applications	Approved (SSIs)	Loans to SSIs (1)	Loans to all industry (2)	(1)/(2) %
1975	52	8	3	151	1271.4	12
1976	36	12	7	569.2	1884.7	30
1979	-	16	16	714.7	714.7	80
1980	-	20	17	1673	1733.8	96
1982	82	23	20	980	1524.1	64
1983	-	13	7	345	1795	19
1987	111	29	29	14467	16467	88

Source: Sudanese Industrial Bank, Annual Reports, various issues.

(iv) Activities of the bank are constrained by the problems facing industry in general such as inadequate infrastructure, a skilled labour shortage, poor management and other constraints.

(v) The problem of supplying working capital to industries which depend on raw materials. Some industries need raw materials which are available only in certain seasons. The bank's law did not allow it to finance raw materials. In 1985 the law was amended, and since then the bank has been granting working capital loans.

(vi) According to its by-law, the bank may not invest, by loan or guarantee, in any one private industrial enterprise, more than the following percentage of its equity capital: 15%, if the private industrial enterprise is owned and operated by a co-operative society or limited company; 10%, if the private industrial enterprise is owned by a partnership, and 7% in all other cases. This financing strategy is based on the assumption that the applicant is able to attract in start-up capital, and is

thus contradictory to the main objective of establishing a specialised industrial bank.

(vii) Regarding creditors of financing, the Bank requires security for any loan guarantee it issues. Thus, the firm's building, fixed plants and machinery, are subject to a first mortgage for the period of a loan. It was stated in the Bank's policy that the total value of the mortgage item should not be less than 120% of the approved loan, otherwise an extra mortgage was required, (see section 10.2 above). Moreover, the plant should be insured in favor of the Bank throughout the period of the loan. This proves that SIB is security-oriented, and questions critically the fundamental difference between commercial banks and development banks like SIB in providing development finance to small firms.

(viii) The other factor which might undermine an objective behind the establishment of SIB is the cost of finance. Throughout the period 1962-70, the interest charged by the bank was 8.5% on medium-term loans (i.e. 2 to 6 years), 9.5% on long-term loans (i.e 6 to 15 years). Then the interest rates on both types of loans were increased to 14% and 15.5% till 1980 respectively. In early 1984, the Bank's Act and Bye-law were amended to comply with the Islāmic *shari'a* code. The Bank started lending money on *murābaha* and *mushāraka* basis, the terms of which included a penalty in the case of delay or default (although this practice is contradicting the Islāmic viewpoint on *murābaha* and *mushāraka*). The Bank's profit margin is between 17% and 21% under *murābaha* finance, and the range of profit sharing is between 30% and 40% under *mushāraka* finance. Moreover, a commitment charge at the rate of 2.5% per annum is charged on signing a loan agreement.

The point is that, although the finance charges of the Bank are slightly lower than those charged by the commercial banks, they are very high compared to other countries. The higher cost of finance accompanied by stringent security is fair enough indication of the difficulties facing SSIs in raising institutional finance in the Sudan. Compared with the ICFC in the UK, and the SBA in the USA and their experience with small firms there, SIB played a very minor role in enhancing the financial position of the SSIs in the Sudan. Thus, there is a Macmillan gap in its institutional dimension. Moreover, more than 50% of the small firms financed

by the SIB were found to be located in Khartoum. Finance for firms in rural areas was very limited. The Bank has no branches outside Khartoum.

10.4.3 The Sudanese Rural Development Finance Company (SRDFC)

The SRDFC was founded in 1981, as a subsidiary company of the Sudan Rural Development Company (SRDC) with an authorised capital of LS. 10 million. SRDFC started operations in 1982, with an issued capital of LS. 3.2 million (32% as ordinary share capital). 60% of the paid-up capital was subscribed by European institutions, and 40% by Sudanese parties. The objective of the company, as stated in the Article of Association, is

'to meet the need of medium and long-term capital finance, as well as technical assistance to commercially viable small and medium-scale enterprises, principally in the private sector', (SRDFC, Article of Association, 1981).

Such an attempt by Sudanese commercial banks and foreign banks is a confirmation of the financial difficulties that smaller firms face in raising and securing institutional long-term finance. This sort of institution is similar to the ICFC (UK) and SBA (USA). The main difference between SRDFC, ICFC and SBA is that ICFC and SBA were founded on a comprehensive research work and consequent detailed policy under government sponsorship, whereas SRDFC was set-up by foreign and domestic owners with the object of financing commercially viable projects. This difference implies the existence of a small business conceptualisation gap in the Sudan.

As mentioned above in section 10.3, SRDFC has not maintained a clear and precise definition of a small business. The definition used by the Company related to the volume of finance and to geographical area. However, with the exception of one or two firms, the company files demonstrated to us that all firms financed by SRDFC had labour force of fewer than 25 employees. Thus, the operations and financing of SRDFC are restricted to rural areas and to towns other than Khartoum. This policy, which characterises SRDFC, is initiated as a development factor to help reduce finance gap in rural areas; in this manner, SRDFC is similar to the Welsh Development Agency and Scottish Development Agency in the UK.

10.4.3.1 SRDFC: financing activities

SRDFC extends finance in the form of equity participation, *murābaha* or other forms and combinations thereof which comply with the Sudanese law. In financing under the *shari'a* code, the *murābaha* loan agreement has been selected as the financing instrument.

SRDFC finance would be in foreign or local currency or a combination of both. The question here is of whether to lend in foreign currencies, where the imported production inputs require the use of foreign funds, or in the Sudanese pound. The prevailing exchange rate (market rate) was used by the company in calculation of loans at the repayment time. This practice proved discriminatory to small firms, and favoured large ones which were able to raise institutional long-term finance from financial institutions at the official exchange rate.

The following limits are observed as a guideline for the size of enterprise qualifying for SRDFC finance: SRDFC finances up to 50% of total project cost; (ii) its maximum contribution in a single project is US\$ 500,000, if the cost of a project is greater than US\$ million; the company participates only with other investors, as joint-venture. However, investment by a third party(s) alongside SRDFC and the project sponsor himself/herself is encouraged by the management of the company. Within the maximum ceiling of financing, the financing power of the management of SRDFC could be defined as follows: (a) up to US\$ 30,000 the general manager; (b) up to US\$ 100,000 the finance committee and (c) more than this and up to US\$ 500,000 is delegated to the board of directors.

The SRDFC's financing strategy, being of a long-term nature, is a good vehicle to eliminate or close the identified small business finance gap. The main and clear limitation of this financing strategy, is that the company provides finance only to an entrepreneur who is able to raise 50% of the total cost. In addition, SRDFC is itself operating with meagre financial resources.

Table 10.8 shows that SRDFC finance targetted small agricultural and industrial establishments, with the industrial investment being the dominant. The financing strategy advantages newly established projects. The finance is given for fixed assets as well as initial working capital. An average loan per project is LS.

Table 10.8: SRDFC: Finance to SSIs, (LS. 000s)

	1983/84		1984/85		1985/86		1986/87	
	Amount	%	Amount	%	Amount	%	Amount	%
Agriculture	643	16	214	14	1200	20	1100	57
Industry	2769	70	1292	86	3800	62	835	43
Services	531	14	-	-	1100	18	-	-
Total	3943	100	1506	100	6100	100	1935	100

Source: Sudan Rural Development Finance Company, 1989.

Table 10.9: SRDFC: Structure of Profit Margins

Amount (000's)	Repayment period (month)	Fixed charge (per annum) %
Less than LS. 250	1-12	20-25
Less than LS. 250	13-25	26-30
Less than LS. 250	23-30	31-40
More than LS. 250	short period	20-25
More than US\$ 100*	short period	18
More than US\$ 100*	long period	20-25

• Repayment in US\$ at exchange rate at due date. * Repayment at exchange rate prevailing at date of dispersion.

Source: Sudan Rural Development Finance Company, 1989.

225,000. The unutilised capacity (40% in 1986/87) can be justified on the ground that SRDFC is at an early stage of operation with a conservative attitude.

In determining the cost of financing in SRDFC, the volume, type of finance, term of financing and the repayment period are used as yardsticks. The cost of finance is calculated on a simple annual rate. Financing under *murābaha* instrument is based on a predetermined cost, accompanied by a penalty charge over delay or default. This practice is an obvious violation of the *shari'a* code. The structure of profit margins adopted by the company could be summed up as shown on Table 10.9 above.

Compared with SIB or even with commercial banks, the cost of lending is high for small firms dealing with SRDFC. This practice challenges the theoretical foundation of SRDFC as a financial development agency. Regarding delay in payment or loan default, the company charged the client a 25% penalty for the first two months, 40% for a delay period of two to six months, and 50% for a delay exceeding six months.

The loans and financing provided by SRDFC are usually secured by mortgage deeds and guarantees from a third party(s). For small projects needing less than US\$ 30,000, post-dated cheques followed by a letter of guarantee from a bank or by personal guarantee are acceptable as security. For all loans exceeding US\$ 30,000, loans are provided against mortgage deeds exceeding 200% of the amounts of funds provided. Thus, the guarantee required is difficult especially for investors such as owners of small firms.

From the explanation above, it can be inferred that the operation and financing practices of SRDFC have not been consistent with the main objective of its formation. In other words, whereas the company as set-up with a positive bias towards small business financing, its financing practices, in terms of cost of finance and other conditions of financing, confirm the existence of a small business financing gap in the Sudan in an economic and institutional form.

10.4.4 The Islāmic Investment Company (Sudan) (IICS)

The IICS was set-up in 1982 as a private limited company, owned by FIBS and Dār Al Māl Al Islāmi with an authorised capital of US\$ 10 million. The company started operations in late 1983 with an issued capital of US\$ 3 million (an equivalent of LS. 7.5 million), subscribed by owners on equal ratio. The company was set-up to

'(1) accumulate Muslims' savings and to invest them according to shari'a code; (2) to participate in the economic development of Sudan and, (3) to improve and enhance saving and investment behaviour of the Muslim community', (IICS Article of Association).

10.4.4.1 IICS: financing operations

The company as a financier operates its business as '*muḍārib*' by issuing '*sukūk*

al muḍāraba' (*muḍāraba* certificates) to the public at large. Thus, the financing source for the company is these *muḍāraba* certificates as well as its capital. It was stated in the company policy that *sukūk al muḍāraba* is for one year, which enables the company to make an investment within one year out of the *muḍāraba* resources.⁴³

The company provides finance under *mushāraka* against revaluation of assets as a security for the company investment. The cost of finance is embodied in the profit-sharing agreement, which in most cases is distributed 45% for the company and 55% for the client for profit not exceeding LS. 400,000. If the profit exceeds this amount, it is distributed as 25% for the company and 75% for the client. As usually under *mushāraka* agreement, losses are distributed according to the share in the operational capital.

Table 10.10 reveals that the IICS financing was devoted mainly to large enterprises (49%) rather than small manufacturing firms. This was attributable to the security provided by large firms to the company in a position of *muḍārib*. A striking feature of the company operations is that they were financed from and within the financial resources generated from the issuing of *sukūk al muḍāraba*. This means that an equity capital of the company remained unutilised, a conservative attitude of the company management. It is noticeable from the table that even the fund raised through '*sukūk*' was not used fully, with an average unutilised lending capacity of 13% during the four-year period 1984-87.

• Summary

These are the main institutional sources of finance to SSIs in the Sudan. It is obvious that financial facilities provided by the commercial banks, and the pattern of allocating these facilities provide evidence that smaller firms in the Sudan are at disadvantage in terms of type, volume and conditions of financing. Thus, one would say that commercial banks contributed partly to the small business finance gap in Sudan. Moreover, there exists a large volume of commercial banks' financial

⁴³ The *muḍāraba* certificate is issued for one year so that the IICS liquidates operations annually and either distributes profits to holders of certificates or debit losses to the value of these certificates. The one-year period of operation is called a round.

resources which remain unutilised, and this finding is indicative of the conservative attitude of banks towards small business financing. Banks have been highly security-conscious and profit-oriented.

Financing practices of even the development financial institutions violated the main objective of setting up these development bodies as they have been, as well, both security-oriented and profit-conscious.

Table 10.10: IICS: Analysis of Financing Operations
(LS. 000s)

	<i>Mudāraba</i> Circulations									
	First round		Second round		Third round		Fourth round		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Small firms	421	35	520	16	1747	50	2797	69	5435	46
Large firms	750	63	2526	79	1617	46	950	24	5843	49
Other sectors	26	2	140	5	137	4	303	7	606	5
Total	1197	100	3186	100	3501	100	4000	100	11884	100
Total value of <i>mudāraba</i> certificates (1)	1209		3193		3501		4000		11903	
Unutilised reserves of (1)	12		7						19	
% of unutilised funds	0.1		0.2						0.16	
Capital of IICS (2)									7500	
Total financial resources (3)									22403	
Invested resources (4)									11884	
Lending capacity* (5)									20162	
Unutilised loanable capital (6)									8278	
(6)/(5)										41

* 90% of financial resources

Source: *Islāmic Investment Company (Sudan), 1989.*

Regarding the financial institution policies, there is a small business 'policy gap'. In addition to this, owners of small firms indicated that there was a lack of

information and advice about the financial facilities available in banking system. There is no specialised advice unit for providing information to customers. Hence, there is an 'information gap' and 'advice gap'. However, the next chapter is a comprehensive and detailed examination of the empirical experience of FIBS in financing one brand of SSIs, crafts.

Chapter XI

Financial Assistance To Crafts: The FIBS Experience

11.1 Introduction

As mentioned above, the main theme of this work is to examine the Islāmic credit system in the Sudan and its role in development financing (see Chapters, VII, VIII and IX). Graham Bannock argues that resources are needed to be deployed in smaller firms in order to sustain economic growth (see Chapter X). For this reason, and because the leading Islāmic bank in the Sudan, FIBS, has initiated and is sustaining small crafts, this chapter is an empirical examination of FIBS' experience in this concern. FIBS set up a specialised branch for this purpose, referred to throughout this chapter as the crafts branch.

It has been mentioned in Chapter X that the SSIs in the Sudan face a 'finance gap' and 'information and advice gaps'. Financial institutions, either commercial banks or the specialised development bodies, are partly responsible for the existence of such gaps. This chapter is a critical evaluation of FIBS' attempt to solve these identified gaps with reference to one type of SSI: the craft activities.

11.1.1 The Crafts units: sampling

This empirical examination is the result of a fieldwork carried out in the Sudan during the period February-April 1989. As a part of evaluating, in general, the experience of the Sudanese Islāmic banks in development financing, the aim of this fieldwork is to assess the role of FIBS in financing crafts.⁴⁴ A craft unit is defined here as a small firm which uses simple technical equipment in an industrial activity to produce a commodity or provide a service.

(i) Total and sampled population

⁴⁴ Throughout this chapter, the term crafts refers to crafts units or firms in Greater Khartoum.

The crafts branch undertook a primary survey of the crafts units in an urban area, Greater Khartoum, in 1986. The total number of units was found to be 948, distributed as follows: 36% in the industrial area of Khartoum, 25% in Northern Khartoum and 39% in Omdurman, (FIBS, Crafts Branch, Crafts Survey, 1986).

However, that survey concentrated only on units based in the industrial areas of Greater Khartoum which have permanent workshops. But there are also those who work in streets and open yards without being licenced, and those who use part of their residence as a workshop. Moreover, crafts units in urban areas make up only a fraction of total number of SSIs. Table 10.3 (the preceding chapter) shows that the number of the SSIs units in Khartoum is nearly 2000 (1782 in 1985), representing 27% of SSIs units in the Sudan. A senior official in the Ministry of Industry (Sudan) told us that almost half of the SSIs units in Khartoum area are crafts. The manager of the crafts branch, whom the author interviewed in March 1989, estimated that the number of crafts units in Greater Khartoum was more than one thousand.

For the purpose of this survey, the target population consists of crafts in Greater Khartoum. The total population was sampled so that the sampled population comprises crafts assisted by FIBS. Up to 1987 the number of loans extended by the crafts branch was 2322. Some loans were extended for the same customers, in other words, a customer received more than two or three loans. Customers who received more than two loans and fewer than five were counted in the sampling as receiving one loan. A significant number of loans were for buying mini-buses, taxes, tractors and their attachments. Such loans were also excluded. The total number of loans was cut to 1186. This number was taken as the sampled population. The sample size was taken to be 10% of this sampled population, i.e. ≈ 120 .

The total number of questionnaire forms distributed was 125. The total number collected was 111. Sixteen of the forms filled in by craftsmen were either incomplete or inconsistent. The net outcome of the sample size was 95.

The method used in selecting the sample was *simple random sampling*, (see Chapter VII, section 7.5.). The questionnaire forms were administered by three research assistants (university graduates).

other words, the conditions affect the preference of craftsmen so that they apply for credit on a *murābaha* basis rather than *mushāraka*. Therefore, the lack of equity finance might be attributed to these conditions.

However, to test this argument or finding, the chi-square test is used here so that:

The null hypothesis should state that the variables (conditions of modes as specified by the branch, and the modes themselves, *murābaha* and *mushāraka*) are independent of one another (i.e. the chi-square is not larger than would be expected by chance.)

The alternative or research hypothesis should state that the variables are related or dependent (ie. the chi-square is larger than would be expected by chance).

Following the techniques of calculating χ^2 , the calculated value (χ^2) is found to be 0.42. The significance level chosen is 0.05, and the degree of freedom is 3.

Comparing 0.42 to the critical value (the distribution value), since the calculated value is lower than the critical value (= 7.815 at 0.05 probability level), i.e. since $0.42 < 7.86$, the decision to be made is to accept the null hypothesis and reject the research hypothesis at all levels. The conclusion is that there is no relation between the conditions of modes as specified by the branch and the preference of mode by craftsmen. Thus, the lack of equity finance is not attributed to the conditions of modes. The craftsmen themselves apply for and prefer *murābaha* rather than *mushāraka*.

11.6 Assisted Crafts Units: Assessment of Financing Activities

This section investigates in detail the conditions of granting credit by the branch as experienced by the craftsmen who received these credits; it further elaborates the assessment of craftsmen to these conditions and whether or not the craftsmen regarded them as a hindrance to deal with the branch.

11.6.1 Repayment period

Craftsmen were asked to show the repayment period of the loans they received from the branch. Revealed responses are shown in Table 11.11.

(ii) To contact crafts would require statistics and information about these firms which is not available, thus it would be time-consuming to contact them, and the cost would be prohibitive.

The fact that only crafts in urban areas were addressed may be seen as a shortcoming. Even then, it is certain that some of the craftsmen who were addressed in urban areas were in fact from rural areas. 54.2% of craftsmen who filled in the questionnaire-forms indicated that they are from rural areas (outside Khartoum).

(iv) An analysis of survey results

Though it was lengthy, the questionnaire was straightforward. The questions were basically concerned with the financial position of crafts, their business relationship with the branch, the possibility of obtaining credit, and their ability to fulfil conditions for credits. The SPSSX programme was used in analysing the materials collected.

11.2 Crafts: socio-economic characteristics

11.2.1 Social characteristics

(i) Providing a source of income

It is important to point out the contribution of the crafts sector in providing a source of income to people. The level of contribution is determined by the proportion of population depending on that sector. Due to limitations of the survey, it is difficult to assess fairly the role of the sector in this concern. Despite that, the survey finding reveals that 89.5% of the craftsmen who were addressed with the questionnaire are married, and 11.5% are single. Married craftsmen were asked to indicate the number of their children, or dependents, for whom they are responsible for supporting. 36.8% of the craftsmen support a family of a size between one and five children, 43.2% support six to ten children, 14.7% are responsible for eleven to fifteen children and 5.3% are supposed to maintain more than fifteen children.

Sudanese society is still tribal and its social structure is based on the extended family; an individual is socially as well as religiously responsible for his father,

mother and grandparents. Therefore, when this particular social characteristic of the society is taken into account, it will be found that the number of people who depend on the crafts sector in maintaining their living is larger than that which has actually been indicated by the survey. This provides evidence for the importance and role of the sector in this concern.

(ii) Relationship between real and professional age

The survey results disclose that there is a positive relationship between the actual age of the craftsmen and the years they spent in profession. The sample younger craftsman (aged between 20 and 25 years) remains in the profession for few years (1-5 years) whilst the older craftsman (aged between 46 and 50 years) practices his profession for more than thirty years. Table 11.2 shows that the average actual age of the craftsman in Sudan is 45 years. The crafts activity needs expertise and capital to start up. Therefore, it is not easy for the younger to have their own workshops. Thus, the majority of craftsmen in Sudan started work in their thirties.

Regarding how long they have been or tend to remain in their profession, the survey findings disclose that 28.4% of the craftsmen remain in their profession for more than thirty years, 13.7% remain for twenty six to thirty years, and 9.5% remain for twenty to twenty five years. That is to say, over 50% (51.6%) have practiced their profession for twenty years and more (Table 11.2).

(iii) A relationship between education and profession

Craftsmen were asked to indicate, first, their level of education and, second, if there is a relationship between education and profession. Table 11.3 reveals that 8.5% of the sample craftsmen had either very little schooling⁴⁵ or no-schooling, 36.8% had preliminary schooling, and 16.8% were educated up to the intermediate level. Thus, the proportion of those craftsmen who had preliminary and intermediate education was 53.6% of the sample size. What attracts attention here is the finding that the number of those who had secondary education, and university and technical institution graduates, increased among the craftsmen (37.9%). This

⁴⁵ In Sudan there is a practice of sending children to what is called *khalwa* which is a kind of informal education system to learn the principles of Arabic language and *Qur'an*. It is a pre-preliminary schooling stage.

finding is indicative of the fact that the crafts sector has attracted more educated people in the past few years.

Table 11.2: Crosstabulation: Actual Age by Professional Age

Age	Number of years in profession						
	1-5	6-10	11-15	16-20	21-25	26-30	Above 30
21-25	3						
26-30	3	6		1			
31-35	1	2	1	2	2		
36-40	1	2	3	5	4	4	
41-45	1	2	2	4	2	4	6
46-50	2	1		1	1	2	9
Above 50	2	1				3	12
Total	13	14	6	13	9	13	27
(%)	13.7	14.7	6.3	13.7	9.5	13.7	28.4

Source: Crafts Survey, 1989.

Table 11.3: Craftsmen: Level of Education

Education level	Frequency	Valid percent	Cumulative percent
<i>Khalwa</i>	7	7.4	7.4
No-schooling	1	1.1	8.5
Primary school	35	36.8	45.3
Intermediate school	16	16.8	62.1
Secondary school	13	13.7	75.8
University graduate	9	9.5	85.3
Technical education	14	14.7	100
Total	95	100	100

Source: Crafts Survey, 1989.

However, despite the increasing number of educated people among craftsmen, still the relationship between the type of education (and its level) and the profession

is not strong. The majority of craftsmen (66.7%) have indicated that there is no relationship between their education and profession. In fact, one third of craftsmen receiving education related to their professional career is an improvement. The majority of this group of craftsmen had either secondary education or graduated from university and technical institutions.

(iv) A final important social characteristic of craftsmen is that most of them come from rural areas. 52% of the sample craftsmen were born outside Khartoum. This finding indicates that craftsmen found favourable conditions for work in urban areas, especially with regard to the provision of services, market outlets for products and other facilities not available for crafts activities in rural areas.

The fieldwork has disclosed that though the crafts activity is old, a great development in the number of crafts units occurred during the eighties. This expansion in the number of operating units is attributed to the Sudanese working in Gulf States who invested part of their savings in this sector. However, though the number increased, there has been no new invention, and more recent start-ups have copied those who have already established workshops.

11.2.2 Economic characteristics

(i) Creating employment opportunities

As mentioned in Chapter X, large-scale and capital intensive industries have produced disappointing results in a number of developing countries, and employment through industrialisation has failed to keep pace with population growth. The SSIs sector is presumably characterised by, in addition to other advantages, higher employment generation. The survey findings provide evidence for this in the case of crafts in the Sudan.

Although the sample was chosen randomly, 100% of the owners/directors of the sample units have indicated that they employ workers. More important is the fact that when craftsmen were asked to indicate the blood-relationship with their employees, only 11.5% showed that their employees are from the family, 5.2% replied that employees are relatives (from the extended family), and 9.5% are from either the immediate family or relatives. The majority of employees (73.8%) are

neither members of the immediate family nor relatives of the craftsmen. This implies that the crafts sector is capable of providing employment opportunities. This is in fact important particularly in the case of Sudan where unemployment among school-leavers and even among the well educated people (graduates) is increasing, and the public sector is totally unable to create new jobs, especially with the austerity economic programmes and the huge cuts in government spending.

The fieldwork has revealed that 67.4% of the surveyed units employ from one to ten labourers, 27.4% from eleven to twenty labourers and only 5.3% employ from twenty one to thirty workers. This finding is in consistent with a definition used in Chapter X to define what the term 'small firm' implies.

The total number of workers employed by the sample units is 713. It appears, therefore, that the average employment capacity for each unit is 7.51 labourers. The crafts branch found that total urban employment in the sector was 5181 in 1986. If, as stated above, the total number of crafts units in Khartoum is more than 1000, and if the average employment capacity is 7.51 labourer, it could be suggested that the total labour force in the sector is more than 7,500 in Khartoum. In 1987, 7457 labourers (5255 unskilled and 2202 skilled) applied for posts in government units. The number taken on represented 36.4% (18.7% skilled and 17.5% unskilled) of the applicants, (Economic Survey, 1987/88). Thus, compared with the government, the private crafts sector has more potential and is more capable of creating jobs for workers.

The fieldwork shows that there is a variation in an employment capacity even among crafts units. When crosstabulating crafts categories by the number of employees in each, the SPSSX produces the results shown on Table 11.4.

It is obvious that blacksmiths, carpentry, welding and fitting (mechanical works on lorries) are the professions which absorb more labourers. On the other hand, tyre-repair, battery re-charging and plumbing are less labour-intensive among the crafts units. This may be attributable to the fact that the latter crafts use more modern techniques. In general, recruitment of labour by sector is fairly closed circuit, not directly absorbing many rural migrants or unskilled (school-leavers) job seekers. The requisite skill is the major prerequisite for entry, and this is generally acquired through apprenticeship.

Table 11.4: Crosstabulation: Profession by Number of Employees

Type of activity	Number of employees			Total
	1-10	11-20	21-30	
Cobbler	2	2	-	4 (4.2)*
Blacksmith	25	9	-	34 (35.8)
Carpenter	16	7	2	25 (26.3)
Welder, fitter	9	-	3	12 (12.7)
Welder, resprayer	3	4	-	7 (7.4)
Electrician	2	-	-	2 (2.1)
Tailor	2	4	-	6 (6.3)
Tyre-repair	2	-	-	2 (2.1)
Others	3	-	-	3 (3.2)
Total	64 (67.4)	26 (27.4)	5 (5.3)	95 (100)

* Percentages.

Source: Crafts Survey, 1989.

(ii) Start-up capital (fixed investments)

The fixed capital of the sector is in the form of buildings, machinery, equipments and raw materials. The survey findings disclose that there is a similarity in the size of fixed investments for crafts categories, so that 60% of units –except goldsmiths, battery repair and recharging, baking– started with fixed investments ranging between LS. 1,000 and LS. 5,000. 16.8% of the units started with a fixed capital of LS. 6,000 to LS. 10,000. However, all the craftsmen have indicated to us that they began work without help from banks or government. Thus, more than 75% of the crafts units had only a low fixed investment. On the other side, 5.3% of the sample units had fixed investment ranging between LS. 11,000 and LS. 15,000, and only 4.2% started with more than LS. 100,000 (Table 11.5).

The two units that started with more than LS. 100,000 are in the category of carpentry. But even within this category, fourteen out of twenty five units (\approx 60%) started with the same low capital (LS. 1,000–5,000), and the two firms which started with large capital represented only 8% among the firms of this category. Among the blacksmiths category, 68% (23 out of 34) of the units started with the

lowest level of capital, 18% (six firms) started with LS. 6,000–10,000, two firms started with LS. 11,000–15,000 and only one firm had a capital ranging between LS. 50,000 and 100,000. However, both carpenters and blacksmiths are characterised, among other categories, by a relatively high fixed investment, this implies that they are more dependent on machinery and equipment than other categories.

Table 11.5: Crafts Distribution: Start-up & Current Capital

Type of activity	Start-up & current capital (000s)									
	1-5	6-10	11-15	16-20	21-25	26-30	31-40	41-50	51-100	Above 100
Cobbler	4 (0)*	0 (0)	0 (0)	0 (2)	0 (0)	0 (1)	0 (1)	0 (0)	0 (0)	0 (0)
Blacksmith	23 (3)	6 (2)	2 (4)	0 (3)	1 (1)	1 (0)	0 (0)	0 (7)	1 (5)	0 (9)
Carpenter	14 (0)	4 (0)	1 (2)	0 (1)	1 (0)	1 (1)	2 (0)	0 (0)	0 (11)	2 (10)
Welder, fitter	8 (0)	1 (0)	1 (1)	0 (1)	0 (0)	0 (0)	0 (0)	0 (1)	0 (3)	0 (5)
Welder, resprayer	3 (0)	1 (0)	0 (0)	1 (1)	0 (0)	0 (0)	0 (1)	0 (0)	1 (2)	1 (3)
Electrician	0 (0)	1 (0)	0 (0)	0 (0)	0 (0)	0 (1)	1 (0)	0 (0)	0 (0)	0 (1)
Joiner	1 (0)	1 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (1)	0 (1)	0 (0)
Tailor	3 (0)	1 (0)	1 (1)	1 (0)	0 (0)	0 (1)	0 (0)	0 (1)	0 (2)	0 (1)
Tyre-repair	0 (0)	0 (0)	0 (0)	2 (1)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	
Others	1 (0)	1 (1)	0 (0)	0 (0)	0 (0)	0 (0)	0 (1)	0 (0)	0 (0)	1 (0)
Total	57 (3)	16 (3)	5 (8)	4 (9)	2 (1)	2 (4)	3 (3)	0 (10)	2 (24)	4 (30)
%	60 (3.2)	16.8 (3.2)	5.3 (8.4)	4.2 (9.5)	2.1 (1.1)	2.1 (4.2)	3.2 (3.2)	0 (10.5)	2.1 (25.3)	4.2 (31.6)

* Distribution of units with respect to current (expansion) capital.

Source: Crafts Survey, 1989.

In fact, although for both categories most of the firms started with low capital, firms are spreading throughout the ranges specified for the start-up capital (LS. 1,000–100,000). This implies as well that there is a minimum level for these two categories, and that firms can further expand by obtaining more productive equipment. It would appear that other categories are not characterised by a high level of fixed capital and that they are more dependent on skill of labour.

On the other hand, one notices an increase in the 'current' fixed investment of crafts units, which means that the sector has potential for growth and expansion. Table 11.5 reveals that the number of crafts units which started up within a range of LS. 1,000-5,000 is 60% of the sample units, now (1989), the firms which have

'current' fixed capital within the same range of LS. 1,000-5,000 are only 3.2%. At the other extreme, the firms that started within the high range of 51,000-100,000, were only two firms, yet now twenty four firms work with a capital within this range. Only four units started with more than LS. 100,000, now the number is thirty. All this indicates that the crafts sector is growing and could possibly be developed to contribute more to economic development. However, although 61.1% of the firms indicated that the average annual increase of their sales is within 1-10%, and only 7.4% of the sample firms (seven firms) showed an average annual increase of sales above 25%, it still remains the fact that the sector has potential for growth and could contribute more if it received sufficient support.

(iii) Enhancing import-substitution industries

Products of the crafts sector in the Sudan are varied, and are characterised as being cheap and at different prices. Thus, the sector provides products for people at different prices and according to their incomes.

More important is the fact that the sector has contributed in substituting imported products with local products such as spare parts, metallic compounds, furniture and other necessary products that were hitherto imported.

However, the contribution of crafts is even more considerable in the national income. The crafts branch primary survey (in 1986) showed that total sales of crafts units located in Khartoum were LS. 42 million. Our survey (1989) reveals that this contribution has increased and is large. Though the craftsmen were cautious about disclosing their sales, the survey finding shows that total annual sales for the sample units (95 units) was LS. 9,504,000. On average, the annual sales per unit were LS. 121,147.⁴⁶ Therefore, with the number of crafts units exceeding one thousand, as estimated before, their annual sales (in December 1988) were estimated to be around LS. 125 million.

⁴⁶ This average should be taken with some caution because three firms had sales considerably different from the other firms. One of the three firms had an annual sale of LS. 2 million, another one LS. 500,000 and the third one LS. 300,000. These values are regarded as extreme, as most of the firms (54.7%) revealed sales ranging between LS. 10,000 and LS. 100,000. However, it is the opinion of the author that these extreme values might have rebalanced the average as craftsmen were so cautious about disclosing the exact figures of their sales in order to avoid tax payment. They thought that the research assistants were tax inspectors.

It is noticeable that a large proportion of crafts units' sales are from blacksmiths and carpenters categories. Out of twenty nine firms indicating annual sales above LS. 100,000 (the maximum amount specified in the questionnaire), eleven firms are from the blacksmiths category and nine are carpentry units. Welding and fitting (mechanical works on lorries) comes second to these two categories with respect to annual sales.

(iv) Using imported raw materials

The crafts sector uses a fairly large proportion of imported raw materials. 47.4% of craftsmen indicated that they use imported raw materials, 22.1% use local materials and 30.5% use both local and imported raw materials. A dependence on the imported raw material has an implication at macro level, that it needs foreign currency and at the micro level, that the crafts will be affected by fluctuations in foreign currency prices⁴⁷; moreover, a relatively heavy dependence on the imported raw materials interrupts the production process as these materials are not always available when needed. It is certainly not preferable at all to depend on imported raw materials, but the sector has no option, at least at this stage of the Sudanese economy where the linkage between component sectors of the economy is weak and the economy is still at an early stage of industrial development.

Crafts units depend to a great extent on buying raw materials either from their own savings (45.3%) or borrowing (41.1%). That is to say, 86.3% of crafts units pay for their raw materials by securing cash. 6.3% depend on sharing products with outside parties so that these parties provide raw materials for products; 7.3% of craftsmen take cash in advance from buyers of the products to pay for raw materials. These figures show that more than 50% (54.7%) do not depend on their own sources in buying raw materials. Instead, they are dependent on borrowing, sharing or taking money in advance. Thus, the sector lacks financial support to obtain its raw materials.

11.3 Finance Gap

The question which must be asked is whether the crafts sector faces a finance

⁴⁷ The dependence on imported raw materials proves the weak forward and backward linkages with other sectors of the economy.

gap, and other –information and advice– gaps? In this concern, craftsmen were addressed with the relevant questions to answer. It is vital to see first what the craftsmen need finance for?

Craftsmen appear to need more finance for raw materials (47.4%), then comes the spending on new machines, i.e. for expansion (12.6%); repayment of debt (2.1%) and the least aspect of spending is the wages and salaries of workers (1.1%). Moreover, 36.8% of crafts units need the finance for raw materials and new machines. Thus, spending on raw materials, new machines and both raw materials and new machines account for 96.8% of the total spending of sample units.

The finance gap for crafts units could be identified through the extent to which they depend on institutional financing, i.e., on the frequency of taking loans, the adequacy of credit from banks and so on. On answering the question ‘To what extent you depend on the crafts branch to finance you?’, craftsmen reveal the following responses,

Table 11.6: Dependence on Branch Finance

Degree of dependence	Value	Valid percent
up to 25%	53	55.8
up to 40%	22	23.2
up to 70%	14	14.7
100%	6	6.3

Source: Crafts Survey, 1989.

It is obvious that only few craftsmen (6.3%) depend wholly on the branch in financing their activities, i.e., the branch provides them with 100% of the finance they need or usually apply for. The majority (55.8%) are sponsored only partially by the branch, giving them only 25% of what they need. 23.1% of the firms secure 40% of their financial needs and 14.7% secure 70%. On average, the majority of the sample firms (78.9%) secure less than 50% of their financial needs. This implies that small crafts are under-financed.

Craftsmen were asked again to indicate if the branch gives them all the finance they usually apply for? 17.9% have replied ‘yes’ that they get fully the amount

they apply for, whereas 82.1% have indicated that they usually do not get the amount of credit needed for production.

Crosstabulation gives similar results, when responses to the question 'To what extent do you depend on the branch to finance you?' were crosstabulated by replies to the question 'Does the branch give you all the finance you need?', the following results are produced,

Table 11.7: Crosstabulation: Degree of Dependence by Adequacy of Finance

Adequacy of finance	Degree of dependence				Total
	Up to 25%	Up to 40%	Up to 70%	100%	
Yes	6	5	3	3	17 (17.9)*
No	47	17	11	3	78 (82.1)
Total	53 (55.8)	22 (23.2)	14 (14.7)	6 (6.3)	95 (100)

★ Percentages.

Source: Crafts Survey, 1989.

Again, the large proportion of craftsmen (55.8%) get only 25% of their finance needed from the branch. On the other side, only 6.3% replied that they depend wholly on the funds from the branch.

However, this might be attributed to the lack of good estimates by craftsmen of what they need. The survey results show that 66.7% of the sample craftsmen go to the branch with an estimate of the amount of funds they need according to the trend of demand for their products. It is true that smaller firms still lack financial control and a budgetting system; owners/directors of these firms do not disclose or trust the financial affairs of their business to any one else in the firm. But still, craftsmen can specify, and they usually do, their financial requirements, and they are aware of the market conditions. 66.7% of the craftsmen, as mentioned above, have shown that they usually specify the amount of credit before they bring their case to the branch.

The frequency of applications for credit from the crafts branch is low. Crafts were asked to disclose the frequency of approaching the branch for credit. Only

25.3% of the sample craftsmen usually approach every three months; 34.7% indicated they approach every six months, and 40% come every twelve months or more.

On the adequacy of credit from the branch, craftsmen revealed that, although the size of loans that they get is reasonable, it is not enough. In this concern, 24.2% considered the size of loans they receive is too small, 60.4% considered that it is reasonable and 14.7% obtained the total amount of credit they asked for.

To be certain about the adequacy of finance to branch customers, craftsmen were asked if the shortage of credit is a hindrance to their work. 92% replied 'yes' that it is a hindrance and 8% answered 'no'. Moreover, only 30.2% of customers have revealed that their credit from the branch increased whereas 69.5% replied 'no' that the branch did not extend to them more credit despite an increase in the demand for their products.

Therefore, one could draw the conclusion that there is a finance gap for crafts, (1) that the majority depend to a lesser extent on the branch in providing funds, (2) the frequency of applying for the credit is low, (3) the credit received did not increase for the majority of craftsmen and (4) a shortage of finance is a hindrance to growth for more than 90% of crafts units.

11.4 The Information and Advice Gaps

11.4.1 Information gap

Like other smaller firms in the Sudan, the crafts firms are unaware of all the services provided by the crafts branch. 66.7% of the sample craftsmen said they do not know the range of services which are provided by the branch. Not only that, the majority do not even know the branch credit policy, in the sense that they deal with a bank for only a certain mode of finance (*murābaha* in most cases). 69.8% of the craftsmen do not know the branch credit policy. Moreover, 93.7% of craftsmen are used to using *murābaha* only, and ignore other methods of financing such as *mushāraka* and *murḍāraba*.

On the other hand, craftsmen have indicated also that, apart from dealing with the crafts branch, they ignore as well the conditions of other types of credits

given by FIBS. 75.8% of craftsmen ignore these conditions, and, apart from the Sudanese Industrial Bank, have no idea about other sources of finance for smaller firms. This situation has serious implications, as craftsmen cannot seek other cheap sources of finance, even if these are actually available. However, this statement of being ignorant about other sources is quite obvious in the responses of craftsmen who were addressed by a question about other financial institutions or banks that they may deal with? Apart from the crafts branch, there are only three cases of craftsmen who dealt with the Sudanese Industrial Bank, and one case of craftsman who dealt with Taḍāmon Islāmic Bank.

Hence, it may be said that there is a 'Sudanese' Bolton gap facing the crafts sector. The crafts branch does not help in this regard. The branch is based in an industrial area of Omdurman, and it is far from the crafts units located in Khartoum and Khartoum North.

11.4.2 Advice gap

Concerning the advice on technical, managerial or financial matters, the sample crafts have shown that there is a lack of information and advice. 95.8% of the craftsmen have reported that they did not seek or receive advice from any body. The majority of craftsmen (81%) have indicated that they did not hear at all of any bank or a business firm giving advice services.

In fact there is no body or institution in Sudan to provide financial, managerial or technical advice on small firms' affairs. Banks are, in general, not willing to finance industry, they, therefore, do not provide financial advice and information to crafts units. There is no formal system for advice and information in any type of banks operating in the Sudan. Craftsmen have not yet been familiar enough with the formal banking system, or the consultancy firms, and the cost of advice provided by private consultants is too high for smaller businesses in general and crafts units in particular.

Thus, the above discussion suggests that there is an information and advice gap facing crafts units. This gap is identified as a lack of information on financial facilities available to craftsmen and the non-existence of any body for providing this advice. One would say that this empirical investigation, based on the experience of

FIBS with crafts units in urban areas, points to an existence of 'Bolton gap' with respect to information and advice. Of course, craftsmen on their part contributed to an existence of such gaps by being less careful about seeking these sources of finance.

11.5 Crafts Funding By FIBS

FIBS set up a specialised branch to sponsor crafts units, to activate this sector which is not accounted for by other banks and is considered as non-banking group. The branch was founded partly to apply the 'specialisation approach' in the process of branching expansion of FIBS. FIBS believes as well that this sector is productive and has potential for growth. The branch started in 1979 to, (1) provide the craftsmen with the necessary machinery and equipment, (2) reduce the costs of these production inputs compared with their costs elsewhere by obtaining and selling them directly to the craftsmen without intermediaries and at low profit margins, (3) arrange repayments and instalments so that craftsmen could obtain equipment easily.

The branch raises its own sources mainly from crafts. Its deposits increased from only LS. 182,000 in 1979 to nearly LS. 10 million in 1983 and to LS. 23.3 million in 1986 (see Chapter IX, Table 9.2). As a percentage to FIBS' total deposits, its deposits increased from 1% in 1979 to 3% in 1982, 6% in 1985 and 7% in 1986. This provides evidence for what has been stated in the preceding chapter that smaller businesses sector could be a net lender to the financial market. If the sector grows and banks help to bridge the finance gap, these advantages could become even more attractive to banks which have suffered in other areas from competition with each other.

11.5.1 Conditions under which finance is provided

Applicants are normally recommended by other customers or bankers. A craftsman is required to show an identifier proving his/her membership of the National Crafts Federation. This is important for the branch to be certain about the professional ability of a craftsman and that he has a workshop to undertake work or a licence to start work. Applicants are also required to prove the feasibility of the

project for which they need finance, therefore the branch officials pay a preliminary visit to the workshop.

The branch sells equipment either in lump sum or by instalment. When sale is by instalment, the following conditions are to be satisfied:

(i) That the customer opens an account with the crafts branch or other branches of FIBS.

(ii) He/she pays 25% as a first instalment according to the conditions of credit extension specified by the Bank of Sudan.

(iii) The maximum repayment period is three years.

(iv) The branch conditions a guarantee for the remaining balance after payment of the first instalment. If that balance is LS. 50,000 or less, the bank accepts a 'personal guarantee' qualified for payment on behalf of the client on default.

(v) The branch accepts an investment account in foreign currency – a minimum US\$ 3,000– as a guarantee.

(vi) If the remaining balance is above LS. 50,000, the branch asks for a real estate guarantee.

(vii) Sometimes the branch takes goods as a guarantee, such as raw materials, which are stored with the branch and it releases these goods on demand after payment of the value.

(viii) The goods under consideration are secured with the Islāmic Insurance Company.

(ix) The branch opens an account under the name of the client in order to facilitate repayment and follow-up.

11.5.2 Financing activities

Table 11.8 displays the contribution of the crafts branch in funding crafts over the years 1981-1987. It is clear that investments in crafts increased over the years under review. The credit was deployed to import machinery and equipment for

the various crafts activities, including spare parts; equipments for chemists and veterenaries, tractors and their attachments and other production inputs. It was deployed as well to buy equipment from the local market, and provide raw materials from local and foreign markets.

Investigation of loans extended by the branch reveals that the size of a single loan is generally small. It varies from LS. 1,500 (in 1989) to more than LS. 100,000. It depends on the cost and category of equipment and machinery.

Table 11.8: Crafts Branch: Extended Loans

	Number of loans		Total finance (LS. million)	
	each year	Cumulative total	each year	Cumulative total
1981	203	203	1.2	1.2
1982	152	355	1.5	2.7
1983	208	563	2.4	5.1
1984	238	801	2.3	7.4
1985	325	1126	4.1	11.5
1986	496	1622	6.7	18.2
1987	700	2322	11.0	29.2

Source: FIBS, Special Report, 1987.

However, it has been shown above that the majority of crafts are still under-financed, that more than 55% of crafts units get only 25% of what they actually need or what they apply for. Only 17.9% replied that they are given the the amount of funds they apply for (Table 11.7). Despite that, the contribution of the branch is better than that of other financial institutions.

Table 11.9 reveals the financial assistance extended by the crafts branch compared with other financial institutions for 1986. It is quite clear that the branch exceeded all other institutional sources of finance to crafts firms. Both the number of firms assisted and the volume of assistance exceeded that given by other banks and financial institutions. If one adds the finance extended to the crafts sector by other branches of FIBS, the contribution of FIBS in this area is formidable as contrasted with other banks. Thus, the total fund given by the crafts branch

in 1986 was 32% of the total finance extended to these units in urban areas, and excluding the branch share from the total, the percentage rose to 46%.

In terms of number of assisted firms, the branch extended credit to thirty six crafts units in urban areas out of sixty two units which received credit in that year. However, the amount of credit given by the branch shown on Table 11.9 excludes the funds received by the crafts in rural areas and the fund allocated to other categories such as retailing trade (buying refrigerators and freezers), chemists and veterenaries' equipments, tractors and their attachments and micro-buses and taxes.

Table 11.9: Institutional Assistance to Crafts, 1986

	Number of units	Total finance	Minimum loan size	Maximum loan size
crafts branch (1)	36	586925	450	88000
FIBS (other branches) (2)	6	775000	10000	500000
Commercial banks	5	301000	18000	200000
SIB	3	62000	9000	36000
Other IBs	2	40000	15000	25000
SRDFC & IICS	2	26000	12000	14000
Other sources*	5	63500	1500	30000
Total (3)	62	1854425	-	-
Total* (4)	1267500	-	-	-
Total* * (5)	492500	-	-	-
(1)/(2) %	32	-	-	-
(1)/(4) %	46	-	-	-
(1)/(5) %	119	-	-	-

* An informal sector; * excluding (1); * * excluding (1) and (2).

Source: Crafts Survey, 1989.

An important feature characterising loans extended by the branch is that they include small-size loans, even though the cost of controlling and administering these loans is relatively high. As it is shown on Table 11.9, the minimum size of a loan is LS. 450, and the number of loans is large, (see Table 11.9). Hence, the

branch is very much concerned about the sector and its growth despite the cost of administering this type of small-size loans.

Other sources of finance extended not only limited funds, the size of loans they grant is larger than that of the crafts branch. This practice excludes many smaller firms from getting financial assistance, as some financial institutions impose high minimum size cut-off points, and are discouraged by the disproportionately high cost of processing applications of small crafts.

In terms of costs of finance, the crafts branch conducts its lending at lower costs for crafts. Craftsmen were asked to indicate the profit margins they paid on credits. 10.5% have said they pay 5% per annum, 27.4% pay from 6 to 10%, 35.8% pay from 11 to 15% and 21.1% pay 16-20%. In other words, 97.9% pay a maximum profit margins of 20%, and only 2.1% pay above 20% on loans provided by the branch.

Comparing the crafts branch with the SRDFC, the cost of lending with the former is lower than that of the latter. For the SRDFC, the minimum profit margin (per year) is 20% and it might reach 40% for a repayment period of thirty months (see Chapter X, Table 10.9). Moreover, an average loan from the SRDFC is LS. 225,000, whereas the minimum loan from the crafts branch is found to be LS. 1,500. Hence, crafts units, in this way, have more access to get credit from the branch than to get a loan elsewhere.

It is also uncovered by the survey that the crafts units supported by the branch has an average lower capital investment than the firms assisted by other financial institutions. The average capital for the units funded by the crafts branch is LS. 21,162, whereas the average capital for firms supported by other banks is LS. 62,200. In addition to this, 96.8% of the crafts units funded by the branch are, in nature, productive units, producing commodities whereas only 3.2% are extending services.

However, one notices the insignificant share of 'equity' finance in the total loanable funds of the branch. When craftsmen were asked about the mode of finance they use, 93.7% reported that they use *murābaha*, whereas only 6.3% use *mushāraka*, i.e. there is a concentration on trade finance as contrasted to equity

finance. When craftsmen were asked again to show if the branch imposes certain mode, 35.8% have said 'yes' and 63.5% 'no' that they are free in choosing the mode.

It would seem therefore that the branch accommodates the crafts units with working capital only rather than the start-up capital or innovative capital, i.e., equity finance. Responses of crafts on the question about the aspects of spending (classified earlier in this chapter) provides evidence for this. As said above, 47.4% of the firms (47 firms) need funds– or received it– for raw materials, whereas only 12.6% spend more on new machines. Moreover, the insignificant share of equity finance is also reflected in the finding that still 60% of the craftsmen rent their workshops, 33.7% own workshops and 6.3% have workshops partly rented and partly owned. In other words, the branch has not yet enhanced the sector with respect to fixed investment in the form of either building or machinery.

This lack of 'equity' finance might, however, be attributed to the conditions of *murābaha*, as a form of trade finance, and *mushāraka*, as a form of equity finance. To the craftsmen, according to their understanding, *murābaha* is better with regard to its conditions compared to *mushāraka*. To test the validity of this statement, responses on the question about the 'mode of finance used by craftsmen' were crosstabulated by revealed responses on the question about the 'factors affecting your (the craftsman) choice of the mode'. The results obtained are displayed in Table 11.10.

Table 11.10: Crosstabulation: Chosen Mode by Factors Affecting Preference of Mode

	Easy guarantee (1)	Low profit (2)	Long repayment (3)	All (1 + 2 + 3)	Total
<i>Murābaha</i>	26 (26.23)*	13 (14.05)	28 (26.23)	22 (22.48)	89
<i>Mushāraka</i>	2 (1.77)	2 (0.95)	0 (1.77)	2 (1.52)	6
Total	28	15	28	24	95

* Expected frequencies; $\chi^2 = 0.42$; $df = 3$

Source: *Crafts Survey, 1989.*

It appears that craftsmen prefer *murābaha* as it looks to them more favourable than *mushāraka* given the conditions specified by the branch for each mode. In

other words, the conditions affect the preference of craftsmen so that they apply for credit on a *murābaha* basis rather than *mushāraka*. Therefore, the lack of equity finance might be attributed to these conditions.

However, to test this argument or finding, the chi-square test is used here so that:

The null hypothesis should state that the variables (conditions of modes as specified by the branch, and the modes themselves, *murābaha* and *mushāraka*) are independent of one another (i.e. the chi-square is not larger than would be expected by chance.)

The alternative or research hypothesis should state that the variables are related or dependent (ie. the chi-square is larger than would be expected by chance).

Following the techniques of calculating χ^2 , the calculated value (χ^2) is found to be 0.42. The significance level chosen is 0.05, and the degree of freedom is 3.

Comparing 0.42 to the critical value (the distribution value), since the calculated value is lower than the critical value (= 7.815 at 0.05 probability level), i.e. since $0.42 < 7.86$, the decision to be made is to accept the null hypothesis and reject the research hypothesis at all levels. The conclusion is that there is no relation between the conditions of modes as specified by the branch and the preference of mode by craftsmen. Thus, the lack of equity finance is not attributed to the conditions of modes. The craftsmen themselves apply for and prefer *murābaha* rather than *mushāraka*.

11.6 Assisted Crafts Units: Assessment of Financing Activities

This section investigates in detail the conditions of granting credit by the branch as experienced by the craftsmen who received these credits; it further elaborates the assessment of craftsmen to these conditions and whether or not the craftsmen regarded them as a hindrance to deal with the branch.

11.6.1 Repayment period

Craftsmen were asked to show the repayment period of the loans they received from the branch. Revealed responses are shown in Table 11.11.

The minimum repayment period is twelve months. 45.3% of the sample crafts units experienced a repayment period more than a year and up to eighteen months. 5.3% had loans for more than eighteen months and up to two years. An interesting finding is that craftsmen who had loans for more than two years and up to three years represent nearly 50% (49.4%) of the sample. This implies that with the repayment period, the branch allows customers to pay instalments over a reasonably long period, and any assumed inadequacy on the part of the branch regarding financial support of crafts might not be interpreted by the repayment period stipulated by the branch.

Table 11.11: Length of Repayment Period

Period (months)	Frequency	Valid Percent
12-18	43	45.3
19-24	5	5.3
25-30	18	18.9
31-36	29	30.5
Total	95	100

Source: Crafts Survey, 1989.

In fact, the repayment period is vital as it affects craftsmen to decide on receiving credits. Craftsmen reveal great importance for this condition when they were asked to indicate its relative importance. 89.5% have replied positively that it is important and does affect their decision to receive credit from the branch, and only 10.5% said it is not important and they do not take it into consideration when deciding on receiving loans.

However, the repayment period is truly vital for craftsmen and they are consistent in estimating its relative importance for them. When responses to the question about 'The length of repayment period experienced by each craftsman' were crosstabulated by revealed responses on the 'Relative importance of repayment period on a craftsmans' decision to take a loan', the results obtained are shown in Table 11.12.

Thus, the repayment period is important for those who have loans for a short period (12–18 months), a medium period (19–24 months) and long period (25–36 months).

Table 11.12: Crosstabulation: Repayment Period By Its Relative Importance

Period (months)	Important	Not important
12-18	39	4
19-24	4	1
25-30	14	4
31-36	28	1
Total	85	10

Source: Crafts Survey, 1989.

It is mentioned above that nearly 50% of the craftsmen had loans to be paid within more than two years, that repayment period is important for craftsmen and that they are consistent in indicating its relative importance. If, then, this is the situation, and the repayment condition stipulated by the branch is favourable for craftsmen to have more loans, one would expect craftsmen to increase their credit. On questioning craftsmen about 'Whether they did increase their credit', only 30.5% reveal an increase and the majority (69.5%) show no increase. The question is, if the 'repayment period condition' seems flexible, why the majority of craftsmen have not increased their credit? So the validity of the argument or the finding 'repayment period condition is flexible' needs to be tested!

To do that, responses on the repayment period experienced by craftsmen were crosstabulated by replies on the question 'Did the credit you get from the branch increase?' and chi-square test was carried.

To set up a test of hypothesis, using chi-square, and according to the argument under consideration,

-The null hypothesis should state that 'the repayment period condition' and 'the increase in credit' are not related or are independent of one another, so that the increase in credit is not attributed to the condition of 'repayment period'. In this case, the chi-square value is not larger than would be expected by chance.

-The alternative or research hypothesis should state that the variables are related or dependent (i.e., the chi-square value is larger than would be expected by chance).

Table 11.13: Crosstabulation: Repayment Period By Increase in Credit

Period (months)	Yes	No	Total
12-18	15 (13.13)*	28 (29.87)	43
19-24	2 (1.53)	3 (3.47)	5
25-30	4 (5.59)	14 (12.5)	18
31-36	8 (8.85)	21 (20.15)	29
Total	29	66	95

* Expected frequencies; $\chi^2 = 1.29$; $df = 3$.

Source: Crafts Survey, 1989

Selecting a probability level of 0.05, the calculated value ($\chi^2 = 1.29$) is compared to the critical value (the distribution table value) at degrees of freedom equal 3. Since the calculated value ($\chi^2 = 1.29$) is lower than the tabulated value ($=3.81$), $1.29 < 3.81$, the decision to be made is to accept the null hypothesis and reject the research hypothesis.

The conclusion is that, there is no relationship between the 'specified repayment period condition' and the 'increase in credit'. In other words, the 'repayment condition' has not been the cause for craftsmen not to increase their credit, and this might be attributed to other factors. The argument that 'repayment period condition is flexible and favourable to craftsmen' is valid, and in this respect the crafts branch has contributed positively in easing one of the important factors affecting the decision of craftsmen to get credit.

11.6.2 Grace period

Craftsmen were asked to reveal the grace period of loans they have received from the branch. Responses that they have revealed according to their empirical experience in this regard is shown in Table 11.14.

Contrary to the repayment period, the grace period seems to be short. Most of the cases have experienced grace period of six months (89.5% of the cases), 4.2% of craftsmen received loans with 7-9 months as a grace period, 1.1% of the sample crafts units had no grace period for loans they received, and only 5.2% have received credits with a grace period of 10-12 months. This finding indicates that the grace period is too short for craftsmen and it might affect their decision to increase their credits from the branch!

Table 11.14: Length of Grace Period

Period (months)	Frequency	Valid percent
0	1	1.1
3-6	85	89.5
7-9	4	4.2
above 12	5	5.2
Total	95	100

Source: Crafts Survey, 1989

Table 11.15 shows the crosstabulation of responses on the 'grace period' – as experienced by craftsmen– by responses to the question about 'An increase in credit'. As is revealed in the table, the 'short' grace period influenced craftsmen not to increase credit so that 70% of craftsmen (86 craftsmen) who had a 'short' grace period, did not increase their credit for that reason. On the other hand, 4 out of 5 cases (80%) with a relatively longer grace period have increased their credit.

The conclusion is that, although the branch stipulates a flexible repayment period, it adopts such a 'grace period condition' that has had negative impact on the willingness of craftsmen to increase loans. Therefore, the finding 'credit did not increase' has partially been prompted by the 'stipulated short grace period'. However, it is important to be cautious about this conclusion, because when craftsmen were asked about the relative importance of grace period, 68.4% have indicated its relative importance for their decision to ask for a loan, while 31.6% have rejected that importance. They, thus, do not give the same weight to this condition as the case with the repayment period condition.

Table 11.15: Crosstabulation: Grace Period By Increase in Credit

Period (months)	Yes	No
0	1	0
3-6	24	61
7-9	0	4
10-12	4	1
Total	29	66

Source: Crafts Survey, 1989

11.6.3 Profit margins

It was mentioned above that the branch is conducting its financial activities at a relatively lower cost than other financial institutions such as the SRDFC. This does not imply, however, that the branch does not discourage some craftsmen by imposing high costs on loans. The statement needs more investigation.

The sample craftsmen revealed that they pay the following profit margins on loans they receive from the branch, (Table 11.16).

37.9% of the craftsmen pay up to 10% as profit margins on loans, 73.9% pay 15% and 94.7% (cumulative percent) pay up to 20%. Only 3.2% pay between 21% and 25% and more. The cost of lending looks reasonable compared to the cost of lending by other financial institutions. One could also say that the branch's loans are cheap taking into consideration the cost of administering and processing small-size credits. It is, as well cheap under the conditions of inflationary pressures and low level of real rate of return on money in the Sudan.

This statement does not, by all means, invalidate the argument that profit margins might possibly inhibit craftsmen from taking loans. Now it is appropriate to consider this question.

The impact of the profit margin on a decision to take a loan will be elaborated here at two levels, first, at the level of craftsmen and, second, at the level of the branch.

Table 11.16: Crafts: Profit Margins on Loans

Profit margins (%)	Frequency	Valid percent
0-5	10	10.4
6-10	26	27.4
11-15	34	35.8
16-20	20	20.8
21-25	3	3.2
25	1	1.1
Above 25	1	1.1
Total	95	100

Source: Crafts Survey, 1989.

First, at the level of craftsmen, and compared to other conditions, it seems that craftsmen give little importance to the profit margins. Craftsmen who assigned great importance to the profit margins (44.8%) are less than those assigning less importance (54.2%). These two figures are close. It would seem that craftsmen are evenly split. However, it is the view and perception of the author that this result is attributed to a considerable extent to the lack of information (information gap) on other sources of finance –if any. As stated above, the information gap is formidable so that 70.5% of craftsmen know of no other sources of finance, that 71.6% do not have financial controller or a regular file system. Therefore, had craftsmen more access to institutional financing, and had they adequate information on sources of finance, they would have increased their credit with the banks.

The 'low priority' given by craftsmen to the impact of profit margins is also obvious from the outcomes of crosstabulating profit margins by revealed responses on an estimation of relative importance of these profit margins, (Table 11.17).

Figures in the table show that even the groups of craftsmen who receive loans at relatively high costs (more than 10%) have indicated less importance for the profit margins. It is, of course, true that no businessman likes to pay high costs on borrowed money, but in the case of crafts firms, information on other sources of finance is very limited, the financial market is fragmented and there is no com-

petition among financial institutions. So, for a craftsman, the last resort will be the single supplier of loans—regardless of the cost of borrowing at this stage.

Table 11.17: Crosstabulation: Profit Margins By Their Relative Importance

Profit margins (%)	Relative importance		Total
	Important	Not important	
0-5	6	4	10
6-10	10	16	26
11-15	16	18	34
16-20	8	12	20
21-25	1	2	3
25	1	0	1
Above 25	1	0	1
Total	43	52	95

Source: Crafts Survey, 1989.

Second, more important is the impact of the profit margins as specified by the branch on the demand for credit. A comparison with other sources favour the crafts branch as a cheap source of funds. To test this finding, again the profit margins as a cost of lending experienced by craftsmen were crosstabulated with revealed responses on an increase in credit received. The results obtained are shown in Table 11.18.

Following up a test of hypothesis, using chi-square,

-The null hypothesis should state that the variables are not related, in the sense that the apparent finding 'credit did not increase', on Table 11.18, is not attributed to the condition of profit margins (i.e., the chi-square is not larger than would be expected by chance). In other words, the stipulated profit margins are low.

-The research hypothesis should state that the variables are related or are dependent, or the profit margins as a condition to get credit are high so that they discourage craftsmen to obtain more credit, (in this case, the chi-square is larger than would be expected by chance).

Table 11.18: Crosstabulation: Profit Margins By Increase in Credit

Profit margins (%)	Increase in credit		Total
	Yes	No	
0-5	5 (3)*	5 (7)	10
6-10	9 (8)	17 (18)	26
11-15	10 (10)	24 (24)	34
16-20	5 (6)	15 (14)	20
21-25	0 (1)	3 (2)	3
25	0 (0.3)	1 (0.6)	1
Above 25	0 (0.3)	1 (0.6)	1
Total	29	66	95

* Expected frequencies; $\chi^2 = 5.02$; $df = 6$.

Source: Crafts Survey, 1989.

Following the same procedure of chi-square test, at 0.05 level of significance with $df = 6$, the tabulated value is 12.59. Comparing this value with the calculated value ($\chi^2 = 5.02$), since our calculated value is lower than the critical value, $5.02 < 12.59$, the decision to be made is to accept the null hypothesis and reject the research hypothesis. The conclusion is that profit margins – as a loan condition – have not affected the decision by craftsmen not to increase credit from the branch. Thus, the third condition specified by the branch is not a hindrance for craftsmen to seek more credit.

11.6.4 The guarantee

The repayment period and profit margins as specified by the crafts branch for credit extension seem to favour craftsmen seeking more credit. The condition of 'the grace period' is strict, so that craftsmen have been effectively discouraged by that stipulation. The most important of all is the condition of providing adequate guarantee to the bank. This is considered vital as an element among conditions of credit extension that, in most cases, denies smaller firms access to institutional financing. In this concern, does the crafts branch ease the condition of providing adequate guarantees so that crafts units can obtain credit and increase their demand for it?

At the outset it is important to mention here that the sample craftsmen have appropriately given great importance to the guarantee and are consistent with smaller firms elsewhere which encountered difficulties in providing the suitable security to get finance. 58.9% of the craftsmen mentioned that need for a guarantee considerably hinders their access to more bank credit, whereas 41.1% said that it is difficult, but to a lesser extent, for them to prepare the guarantee required. It is not easy for crafts firms to provide such a guarantee.

In extending its financing activities, the branch stipulates that a craftsman should supply the branch with the necessary guarantee so that a loan might be provided. The required guarantee is one of three kinds: (1) the easier one, personal guarantee so that a client is backed by a well-known person, capable of paying instalments on behalf of a client in case of default; (2) joint storage of goods (such as raw materials bought by the branch for the customer) under the auspices of the branch and the craftsman and the latter may regularly take from these goods as he/she pays the value of goods under consideration; (3) the difficult guarantee of providing real estate, including machinery, equipment, or even the workshop buildings, so that the real estate comes under the control of the bank.

The empirical experience of crafts firms with the branch reveals that the branch relaxes conditions so that it is satisfied in most cases with the easier (minimum) guarantee required. On replying to the question about the kind of guarantee provided, 78.9% of craftsmen have indicated that the branch accepted a personal guarantee. 3.2% of craftsmen satisfied the branch by storing goods and 16.8% were given credits on provision of the difficult guarantee, the real estate. To provide evidence of the bank's relaxed attitude on this condition, craftsmen were asked again to show if it is difficult for them to provide the appropriate security as stipulated by the branch. Only 29.5% encountered difficulties, and the majority, 69.5%, faced no such difficulties. This is a good record for the branch in easing the guarantee and, in consequence, allowing craftsmen more access to the financial facilities.

Further evidence for this 'assumed' good record is supplied by the figures on Table 11.19.

As the figures show, the majority (56 craftsmen) have indicated the relative importance of the guarantee as a difficulty to get credit, but 60% of those assigning greatly relative importance have not found difficulty in satisfying the branch with the kind of guarantee available to them. In other words, craftsmen have properly assessed the importance of guarantee as a hindrance to get credit in principle, but they have not encountered that difficulty according to their empirical experience with the crafts branch.

Table 11.19: Crosstabulation: Guarantee Difficulty By Relative Importance

Guarantee provision	Relative importance		Total
	Important	Not important	
Difficult	19	9	28
Easy	36	30	66
Total	56	39	95

Source: Crafts Survey, 1989.

However, the apparent finding that 'credit did not increase' for crafts has been tested against other conditions, and apart from 'grace period', the other conditions as stipulated by the branch have not been the cause for this situation. It is important to test it with regard to the final condition of guarantee. As with other loan conditions, the question 'Did the credit you get from the branch increase?' was crosstabulated against the various types of guarantee by craftsmen. The revealed responses, as crosstabulated, are shown below, (Table 11.20).

Looking at the figures on the table, it is clear that even with the 'easier' kind of guarantee, craftsmen have indicated that they have not increased their credit. However, the chi-square test has been carried for the more 'difficult' types of guarantee. Assuming that there is a relationship between the type of guarantee required and the finding that 'credit did not increase', the chi-square test proves that there is totally no relationship ($\chi^2 = 1.82 < 3.841$, i.e., the calculated value is lower than the tabulated value at 0.05 probability level with $df = 1$). The conclusion is that the stipulated kinds of guarantee have not influenced craftsmen to increase credits even though the branch is flexible enough in accepting the minimum type of guarantee.

Table 11.20: Crosstabulation: Type of Guarantee By Increase in Credit

Type of Guarantee	Credit increase		Total
	Yes	No	
Personal	23	52	75
Estate	5	11	16
Goods	0	3	3
No guarantee	1	0	1
Total	29	66	95

$$\chi^2 = 1.83; df = 1$$

Source: Crafts Survey, 1989.

11.6.5 The mode of finance

As a branch of an Islāmic bank, the crafts branch gives credits on the basis of Islāmic mode of finance. Sometimes the distinctive nature of Islāmic mode of finance, e.g. *mushāraka*, discourages some potential investors from taking credit from an Islāmic bank (see Chapter XIII). The crafts branch gives credit on, predominantly, *murābaha* basis as the survey reveals. Some craftsmen do not prefer *murābaha* as the bank does not allow them to use the fund of *murābaha* and it insists on giving goods. So, in this way, craftsmen loose the freedom to use the fund allocated to them.

The key question is whether this affects the craftsmen's decision to seek credit? Responses reveal that 55.8% are not concerned with the freedom to use the fund of *murābaha*, and 44.2% hope and want the branch to give them freedom in using the funds. This indicates that craftsmen have not been affected negatively by *murābaha* mode of finance as a distinctive mode, not enabling the customer to use the fund as he likes. This argument is supported more by the finding that, as mentioned above, 64.2% of craftsmen have reported that they are free in choosing the mode of finance they want and the branch does not impose specific modes.

- Summary

Crafts firms face a finance gap, and information and advice gaps. Of particular importance is the finance gap. The crafts branch has helped in bridging part of this

gap, but still the crafts sector is under-financed. The cause for this has been tackled with regard to the conditions stipulated for credit extension by the branch. An empirical investigation proves that with the exception of 'grace period condition', other stipulations are flexible and have not influenced craftsmen in deciding to increase credit.

However, two possible explanations might exist as a cause for this 'under-finance' situation of crafts sector. It might be explained on the demand side that the firms face a declining demand or other problems or are unable to present their case properly and satisfactorily. Or, alternatively, the cause might be on the supply side, that the branch is itself restricting the total credit to be deployed in the crafts sector. Now, it is appropriate to examine these explanations.

11.7 Under-financed Crafts Sector: Possible Explanations

11.7.1 Demand perspective

The fact that the crafts sector remains under-financed might come from the craftsmen themselves. First, the demand for their products may be inadequate and ineffective so that they approach the branch less frequently and take out fewer loans. However, revealed responses of the craftsmen on this matter show that the demand for their products is high enough and they look forward to expansion. On the level of demand, 66.3% of the craftsmen answered that demand for their products is high, and only 33.7% reported a low level of demand. Not only that, 67.4% have shown that they assess finance they need according to the level of demand for their products. Thus, there is little problem with respect to demand. The argument that the demand is low and that craftsmen cannot assess their financial need will not stand as an explanation for under-financed situation.

Second, on addressing craftsmen with the questionnaire, they reported that some other problems affect their work and, in consequence, affect their demand for finance. Revealed responses are displayed in Table 11.21.

The point is that, because of these problems the production process is interrupted and work stoppage is frequent. The majority of craftsmen agree that the

impact of these problems on their work, and consequently, on their readiness and decision to take loans is great.

Table 11.21: Problems Affecting Demand for Loans

Problems	Frequency	Valid percent
Electricity shortage (1)	8	8.4
Transport (2)	2	2.01
spare parts (3)	9	9.5
Skilled labour (4)	1	1.1
Raw materials (5)	9	9.5
High tax (6)	8	8.4
All problems above	50	50.5
(1) +(2) + (3) only	10	10.5
Total	95	100

Source: Crafts Survey, 1989.

Craftsmen were asked again about the degree of impact of each problem on their work and their demand for loans from the branch. The results obtained are shown on Table 11.22.

As the figures on the table disclose, inadequate supplies of raw materials and spare parts are the most difficult problems affecting crafts work and in consequence their demand for finance. Craftsmen have classified these two problems as a cause of not applying for more loans. Thus, they regard them as a hindrance and these problems have discouraged them to take loans. But, on the other hand, these problems themselves are a result of a shortage of finance by the branch. Therefore one could say that had the branch financed adequately raw materials and spare parts, these constraints would have disappeared.

Other problems are either structural in nature, such as the electricity cuts, or are related to the economic policies of the government, such as tax ratios. It seems that both problems affect the work of crafts to a considerable extent. Their solution lies in the hands of policy makers rather than the craftsmen themselves or the branch management.

Table 11.22: Problems: Degree of Impact

Problem	Great impact		Rank
	Frequency	Valid percent	
Raw materials	75	23	I
Spare parts	72	22	II
Electricity cuts	71	21	III
High tax rates	70	20	IV
Transport	26	8	V
Skilled Labour	14	6	VI
Total	328*	100	-

* Total is not 95 as some craftsmen face, and were asked to indicate, more than one problem.

Source: crafts Survey, 1989.

Third, it has been stated earlier that 93.7% of the branch operations with the sample craftsmen have been executed on a *murābaha* basis. One of the conditions of *murābaha* is an instant payment of 25% of its costs as a first instalment. This is a condition stipulated by the Central Bank. However, 58.9% of the craftsmen have indicated that an instant payment of the 'compulsory' first instalment has discouraged them to take finance. It is not easy for many craftsmen to fulfil this condition, and if they pay the first instalment, they cannot find money to pay for working capital.

Therefore, on the demand side, a state of under-financing exists as there are some problems crippling crafts work, and discouraging them to take loans from the branch. Moreover, the condition of paying 25% of the loan as a first instalment is, in most cases, beyond the capacity of craftsmen. Hence, their demand for credit is dampened.

11.7.2 Supply perspective

It has been mentioned above that only 17.9% of the sample craftsmen who applied for loans from the branch received the full amount they applied for, and 81.3% did not receive the amount they wanted. Moreover, as said before, 30.5% of the branch customers have increased their credit whereas 69.5% did not.

The author had lengthy conversation with the director of the investment division at the crafts branch. The director agrees that it is true that not every applicant is given a loan and/or the amount he applies for. Being asked about the reason, he replied that the following factors, and according to their importance, affect his final decision on granting a loan: (i) past record of the crafts unit; (ii) the number of loans the unit received from the branch and its performance and the size of deposits it keeps with the branch; (iii) availability of information about the firm and availability of the commodity the craftsman needs; (iv) the type of activity of the crafts unit and (v) the availability of guarantees.

However, all members of the sample had received loans from the branch. Their names and files containing documents of their financial dealings with the branch were found in the archive room of the branch. The number of those indicating in the questionnaire forms that they have not had full amount of the finance they wanted is 78 craftsmen. Names of these 78 customers were picked out and brought to the director of investment division to sort out why these craftsmen have not received the full amount of the finance they applied for. Rejection is found to be based on the following reasons:

Thirty seven cases were rejected due to the restrictions of credit ceiling policy, at least at the time when they applied for loans. Because the Central Bank specifies ceiling limits to banks, FIBS, as similar to other banks, distributes its ceiling among its branches. Therefore, in the case of these firms, the cause has not been the unavailability of finance at disposal of the branch as much as it is a cause related to policy, that the branch is not allowed to exceed its ceiling limits.

Sixteen crafts units were not given the funds they wanted on account of defaults in repaying loans received from the branch and bad performance.

Twelve cases were found asking for more than their actual needs and capacity. In such cases, the branch asks an official to visit the workshop, assessing its assets, and collect more information about the production capacity and aspects of spending.

Four cases were rejected as they were not presented satisfactorily and the documentation was incomplete.

Four applications received less than the amount they needed because the type of activity of the craftsmen was not favoured by the branch. In other words, an internal policy of the branch at that time was to reduce finance for such activity.

It would appear that the most important factor affecting the inadequacy of finance to small crafts units is the credit ceiling policy. Thus, though the branch is sometimes prepared to finance, it is constrained by the limited ceiling. This is, in fact, a common problem that face all banks in the Sudan.

The sixteen crafts units which were failing to repay were found facing internal difficulties such as bad management, marketing problems and competition from other crafts units producing similar products, in addition to the problems of electricity cuts, shortage of raw materials and unskilled labour.

Some customers used to ask for more than their actual needs with the view that in the end they will get the amount they need. This practice is common among craftsmen because they have a pre-perception that branch officials always reduce the amount of loan needed. However, in this regard, the director of investment division at the branch replied that the branch does not reduce the amount primarily but according to the actual need of the applicants and after investigation. But the branch management tries to distribute the available resources, already specified by the ceiling, among a large number of craftsmen. This is why as has been noted earlier in this chapter, the loan-size of the branch is relatively small.

A satisfactory presentation of the case affects the branch response towards applicants. Some craftsmen have been discounted as being unable to bring the necessary documents for completing the procedure. This is also a common problem facing banks in the Sudan and affects the bank-customer relationship. The majority of craftsmen do not keep regular records and an adequate filing system. 70.8% of the sample craftsmen have said that they do not keep regular files. These are the things that affect the branch response and its readiness to give funds. Therefore, four cases of this kind were not given their required funds as presented to the branch.

Finally, some craftsmen need funds for goods or commodities for which the branch will not loan money. The branch has priority for granting funds according

to categories of crafts activities.

Hence, these are the possible explanations on the supply side that would appear to explain why some crafts units are under-financed. The director of investment division was also asked why the majority of loans are on a *murābaha* basis (trade finance) rather than *mushāraka* (equity finance)? He has replied that *murābaha* is less risky; the return is quick and the bank is not responsible for follow-up or supervision in the case of *murābaha* as contrasted with *mushāraka*.

11.8 Some economic implications

The economic implications of financing activities of the crafts branch might not be considerable and therefore could not be felt in the short run. The finance gap, and the information and advice gaps that face the crafts units, as one sector of smaller firms, cannot be tackled and therefore solved by a growing – though pioneering – branch such as the crafts branch of FIBS. It might be said that it is a little early to assess this experience. Despite that, some favourable outcomes can be pointed to as a result of the financing activities of the branch.

On employment, it has already been pointed out that all the assisted firms (100%) hire labour and that 73.7% of the labour force of these units come from outside the circle of family or relatives of the owners/directors of the crafts units. craftsmen were asked again about the impact of receiving finance from the branch. 71% said that they have increased employment as a result of availability of more (external) finance from the branch. Thus, the majority have gained from their business relationship with the branch.

On production, 66.7% of the sample units indicated that their production levels have increased. Although it is difficult to know exactly an increase in the volume of production, 35% of the (64) assisted firms, whose production increased, have shown that their production has increased by 10%, 19.8% have experienced an increase of 15%, 18.9% have increased production by 20%, 15.8% of the assisted firms realised an increase of 25% and 9.5% have increased their production by more than 25%.

11.9 Conclusion

As mentioned in Chapter X, the SSIs sector is, in contrast to LSIs, presumably characterised by some development advantages: (a) low import-dependency; (b) high employment generation; (c) use of appropriate technology; (d) generation of local skill; (e) supply of needed goods and services for local and rural markets and stronger linkages to other economic sectors. On the other hand, Sudan's experience with large-scale intensive industries has produced disappointing results. However, despite this, the SSIs in general, and the crafts sector in particular, are constrained by problems affecting negatively their rapid growth and therefore their potential contribution.

It has been explained in Chapter X (section 10.3) that the entire industrial policy in the Sudan is unfavourable for the internal growth of smaller enterprises, and in this respect there is an obvious policy gap. Governments in industrial, as well as some developing countries, have attempted to support the SSIs sector in different ways (see Chapter X, section 10.2.3). However, in contrast to governments elsewhere, the government in the Sudan could be described as deficient in providing the necessary support to the crafts sector. The areas of deficiency are as follows:

There are no incentives or concessions for investment in the crafts sector.

Public corporations and private firms are not directed to support the sector, the government's effort to attract the foreign financial and technical assistance to the sector is very limited.

The policy of protecting local industries from competition of foreign manufactured products is not clear, continuous or strong enough to function. The products of crafts are completely unprotected, therefore craftsmen suffer more than other local industries.

As mentioned above, the survey reveals that the majority of craftsmen do not own their workshops. They depend on rented workshops. In this concern, the government does not provide land or improved services at reasonably low prices.

There is no public policy for subsidising production inputs needed by the sector or even catering for the continuous supply of these inputs.

It is a common problem for all crafts units, that production inputs are not available, especially the scarcity and higher prices of raw materials. Most of the crafts units use relatively small quantities of raw materials, as such, but they cannot import their requirements or buy them at wholesale (lower) prices. Therefore, the crafts units cannot benefit from concessions and import duties and tax exemptions on these raw materials. Craftsmen are in most cases under the pressure of accepting the blackmarket prices of raw materials. Thus, craftsmen have no alternative other than to raise the prices of their products.

Most of the crafts units face the problem of electricity cuts and an inadequate supply of fuel or wood energy. In addition, industrial areas in the three towns (Greater Khartoum) lack even water supply, efficient transport network and other basic services.

The most difficult problem facing the crafts sector is the finance problem. Despite a good record for FIBS in supporting the sector, it remains characterised as under-financed. Internal sources of finance are inadequate, especially with higher prices of production inputs and that a significant number of craftsmen are indebted to other people. The sector is therefore in desperate need for finance to meet operating expenses (raw materials) and start-up and expansion capital requirements.

One of the problems of the crafts sector is marketing of the products. The sample craftsmen reveal that they do not receive services such as marketing facilities from the branch or from any other body. The problem is in general attributed to the following: (1) that there is no protection for the sector's products; (2) an absence of proper distribution channels or marketing centres or show-rooms; (3) the quality of the products and finishing are not yet good enough to compete with other products especially imported products, in addition to the prevalence of copied products and an absence of innovative products; (iv) many crafts units compete with each others and produce the same kind of goods or services; (v) few craftsmen have knowledge of marketing methods.

Chapter XII

Conclusion And Recommendations

12.1 Summary Conclusion

In classical times the outright opposition to usury came from the philosophers and moralists. They considered usury to be morally wrong because it involved paying for time; that usury is the result of the unnatural use of money and contrary to natural law.

The Pre-Reformation Christian and Islāmic standing on usury is that both prohibit usury outright and what is clearly permissible is a return from a partnership. Both call for a share of risk between the lender and the borrower, and no one party is allowed to acquire more advantage at the expense of other partner. Both reject time as a justification for the payment of interest and say that when gain is sought from an activity not in itself productive without labour, expense or risk on the part of lender, this is illegitimate and reprehensive.

An exposition of theories of interest shows that these theories discuss the issue of interest from a different angle, having considered different factors that might affect interest rates. However, all the theories are concerned with the expected rate of interest only. The question of real rate of interest remains untouched. In other words, if both the borrower and the lender of capital, any form of capital, are to get a 'fair' gain from any joint work, negotiation on predetermined interest rate would be unfair for either of the two parties. The economic activity based on actual return, i.e. on a *PLS* basis, is fair and advocated by the Islāmic financial theory.

Modern theories of profit based their views on the subject following the classical economists who addressed the problem as one of dividing social income among the socio-economic classes, landlords, labourers and businessmen calling the share of businessmen as profit.

The classical economists differentiated between interest and profit, but this differentiation was not so clear because at that time capital was almost always employed by its owner. They recognised three elements in the income of the capitalist entrepreneurs, first, a payment for the base use of capital, second, payment representing reward for the entrepreneur's activities as a manager, third, payment to compensate the entrepreneurs for risk. Profit as a unique form of income not reducible to remuneration for either capital or labour was developed by German writers. The socialists, Marx and others, as developing the classical economics, dropped the distinction made by the classical writers. They merged land with capital and regarded profit as including all non-labour income.

In actual society economists commonly use the expression 'pure profit' to refer to the income of the business after deduction of wages and rent or interest for all the human and property services employed in the enterprise. Attempts to present a theory of profit restricted in meaning have taken two main directions: the first centers in the effort to identify a peculiar form of service of which profit is the remuneration. Since the ordinary managerial activities are frequently hired on a salary basis, there left the service of 'risk bearing' as a basis for such theory. The second direction revolves around an examination of the function of management as it is tied up with the nature of a risk which could be *insured*.

However, modified versions of the risk theory differentiated between risk, a 'measurable uncertainty', and uncertainty, an 'unmeasurable risk'. For this theory, unmeasurable risk is associated with economic change. In other words, profit is an uncertain outcome of economic activity in a continuously changing environment. Thus, this viewpoint is identical with the Islāmic view-point of profit as being an uncertain outcome. According to this theory profit and loss arises in many cases from circumstances entirely apart from human foresight.

The *shari'a* advocates the share in profit and in loss for any transaction to be undertaken by partners. That is, instead of working on the basis of *riba*, or in terms of the current economic literature on the basis of *ex ante* interest rates, the Islāmic *shari'a* calls for participation in the *ex post* or the actual result of the work. However, both the Middle Ages and modern history show some attempts to apply

the *PLS* notion. The forms applied were quite similar to the Islāmic methods of finance.

There are many reasons advanced in the literature for the possible instability of the traditional banking systems. Proposals for reforms of this system along the lines of equity participation have been made at various times in the United States especially during the periods of banking crisis. Arguments for the *PLS* system have also been made in the wake of the debt crisis of the LDCs during the 1980's. There has been a revival of proposals for an equity-based system.

The Islāmic banking system may prove to be better suited to adjusting to shocks that result in banking crises and disruption of the payments mechanism.

The interest-based system in fact intensifies the business recession. As soon as the banks discover that business concerns are beginning to incur losses, they reduce assistance, and call back their loans, as a result of which some firms have to close down. This increases unemployment, resulting in further reduction in demand and the infection spreads. IBs, working on the basis of the *PLS*, are prepared to share in losses which reduces the severity of business recession and enables the productive enterprise to tide over difficult periods without closing down.

There are changes in the real world; as soon as interest rates rise in one part of the world, capital starts moving to that part. When the rate changes, massive movements of capital start from one country to another. Under the *PLS* system movements of capital will be guided by the expectations about profits. Fluctuations in the rates of profit will be less than fluctuations in the rate of interest. Therefore, a system based on *PLS* will be more stable than the interest-based system.

IBs have come to existence so as to prove in practice the working of *PLS* system. The Islāmic methods of finance of *muḍāraba*, *mushāraka* and other forms, provide the alternative to the interest-based dealings.

Though, however, they have come to existence recently, IBs have expanded rapidly and at the present time they are actively participating in the international financing. There are, however, some factors that act to the detriment of IBs. These include their difficult relationship with the monetary authorities, the lack of adequately skilled staff and the absence of Islāmic financial instruments which

could help to widen their dealings with the international financial markets. None of issues has been solved and this will continue to affect the growth of IBs.

As it is central for this study, the Sudanese economy has been examined. This economy shares with LDCs most of their economic and related characteristics; the low per capita income, low growth rates, retarded economic development and a dual economic structure. The study shows that the Sudan has a history of interrupted development plans. In contrast to other low-income countries, the Sudan is characterised by high inflation rates. Agriculture is and will remain the key sector of the Sudanese economy for the foreseeable future.

In the Sudan, the marginal propensity to consume and the average propensity to consume are high. With regard to capital formation in the Sudan, the main economic problem has been and still its excessive dependence on the cultivation and export of a few agricultural products. Lack of adequate savings has prompted a recourse to external sources of investment funds. In the Sudan, although the government financed a major share, the private sector played a vital role in economic development.

The main features of the external financial performance of the Sudanese economy are in the balance of payments statements. The balance of payments exhibited a number of structural rigidities. The Sudanese economy is heavily indebted, with rising debt servicing. Due to debt problems, successive governments were and are trying to follow economic policies geared to repayment of debts. Therefore, the Sudanese economy is highly linked with the IMF and its policies since 1978.

Again, for the sake of this study, the financial and banking aspects of the economy have been investigated. It is found that the Sudanese economy is less monetised. The informal money market in the Sudan is quite dominant due to the existence of financial repression. Therefore, the lending and borrowing mechanism in the informal credit sector, which is less monetised, involves payment of high interest rates.

In the Sudan, banks during the colonial periods served mainly expatriates who were engaged in developing exports of raw materials. Indigeneous people participated in the the process of intermediation as depositors only rather than borrowers.

After independence, a very similar banking system has evolved where favoured private and official borrowers still absorb the limited finance available at low rates of interest. The mass of small farmers and small industrialists remain financially repressed. Together with the government, urban borrowers absorb virtually all of the banks' lending resources. Huge interest differentials between organised banking and informal rural credits is usual in the Sudan as in other LDCs.

The money supply and liquid asset holdings by the public have expanded noticeably over the years. This reflects the growth of the banking system, and further development of a money-oriented economy. The government follows a low interest rates policy. But this policy was not effective. The bank of Sudan has relied primarily on the control of rediscounting, and on quantitative credit controls to manage the money supply. Because the public sector was a major borrower during most of the 1970s, and till now, monetary policies have in general been accommodating and have only become more restrictive under pressures from external imbalances and inflationary tendencies which have required stabilisation programmes.

Faced with a deteriorating balance of payments situation and an increasing inflation rate, the monetary policy in the Sudan has become stricter. Each bank is given a monthly ceiling on credit expansion and is required to keep high liquidity ratios with the Central Bank. Despite this liquidity requirement, the banking system continues to have excess liquidity. In the Sudan, the financial market distortions have been accentuated by intervention policies directed towards keeping the nominal interest rates unduly low and by the enlargement of government deficits financed by recourse to the banking system.

The nationalisation of commercial banks in 1970 was a turning point in the development of the Sudanese banking system and the monetary and credit policies which emanated from it. The measure was taken to develop and improve banking services to various economic sectors, particularly in the traditional areas; putting an end to foreign domination and providing the Central Bank and the government with full power to control credit policies.

However, measured in terms of a number of branches, deposits mobilised and credit disbursed, banking facilities were and are concentrated in urban ar-

eas, whereas the rural areas remain backward so far as the growth of banking is concerned. The banking system has been latter affected by the programmes of economic concentration and financial reforms agreed upon with the IMF and foreign creditors to the Sudan Government.

Private deposits dominate the total deposit liabilities of the commercial banks. Moreover, demand deposits have a big share in total banking deposits. Saving depsoits have shown an impressive growth up to 1977, but are latter characterised by slow growth rate, a cause attributed to the negative real interest rate.

Most parts of the banks' advances were and have been of a short-term nature. The whole pattern of lending has been dominated by the financing of foreign trade. However, although commercial banks are blamed for shying away from long-term investments in productive sectors, some obstacles, apart from the credit policies, forced commercial banks to concentrate on short-term financing. One of these is the absence of capital and money markets for exchanging local shares and securities. In the Sudan, only 25% of the total population are able to benefit from the credit facilities provided by commercial banks. The rest of the community who live in the un-organised money markets are either unaware or largely unable to make use of financial credit which most of them desperately need. As a result, they find themselves exposed to money-lenders who charge exorbitant interest rates. The bulk of the farmers in the Sudan have limited access to the credit facilities provided by commercial banks and the Agricultural Bank of Sudan; and in view of their low level of income, these farmers accept the *shail* credit.

In the Sudan, the empirical evidence shows a positive association between savings and monetisation, a result which implies that the efforts to monetise the subsistence sector will have a favourable effect on savings. Therefore, banks should intensify their efforts to extend more services to rural areas.

IBs have been introduced to the Sudan by establishing FIBS in 1978 with a special law. The initial success of FIBS encouraged policy makers in the country to support IBs development so that there are now six IBs. In 1984 the whole banking system was Islamised by a presidential decree, and concessions were withdrawn from FIBS. Despite the fact that IBs were greatly affected by the regulatory measures

imposed, they are actively participating in the financial and business activities of commercial banks.

Economists have stated different opinions on the effectiveness of banking system in promoting or facilitating economic development. In short, the banking system is one of many institutions that influence the economy and affect its performance for better or worse. A banking system may make a positive contribution to economic growth and development, but its effect may be offset by other factors such as unfavourable resource endowments, or unhelpful government policies. What can be asserted is that any given banking system might, with different policies, be made more or less effective in its contribution to economic development.

FIBS is the first and leading Islāmic bank in the Sudan. 62% of the deposits with IBs are with FIBS. 51% of the Islāmic credit was extended by FIBS. The bank has significantly contributed to the financing of different economic sectors. Most important of all is its initiation and financial sponsoring of the small crafts firms.

Many developing countries began in the early 1950's adopting an import-substitution strategy, which resulted in the establishment of large-scale capital-intensive industries in urban areas. This strategy has produced disappointing results. The experience of Sudan with industrialisation has been similar to that of other developing countries.

On the other hand, the SSIs sector is characterised by some development advantages such as low-import-dependency, high employment generation and use of appropriate technology. However, of many problems facing smaller firms, the question of financing is a critical one.

A review of the literature on small business financing in developed and developing economies identifies different opinions and views to the issue of small business financing. But there seems to be widespread agreement that the main problem for these firms is the inability to obtain sufficient funds to promote growth. This shortage of fund is identified as a finance gap. There are other information and advice gaps facing smaller firms.

Smaller firms in the Sudan contribute in the overall GDP and employment. Compared to larger firms, smaller firms are found to be characterised by low investment/labour ratios, high value added and high investment/output ratios.

Sources of finance to smaller firms in the Sudan are the commercial banks, the SIB, the SRDFC and the IICS. The small firms are at disadvantage in terms of type, volume and conditions of financing.

However, resources are needed to be deployed in smaller firms in order to sustain economic growth. FIBS, as said before, has initiated the financing of smaller crafts units. It set up a specialised branch for this purpose. The branch grows over time and has its own financial resources. Deposits mobilised from the craftsmen have increased. Although the branch has contributed in bridging the finance gap of smaller firms, its role is constrained by some obstacles such as the public economic policies.

12.2 Major Research Findings

12.2.1 IBs: a role in monetisation and market share

The findings of this research depend on the fieldwork analysis presented in Chapters, VII, VIII, X and XI. Thus the major findings from an examination of the experience of the Sudanese IBs could be summarised as follows:

IBs branches constitute 25.8% of the banking system branches, which indicate the relative importance of IBs. Both IBs and commercial banks have the same degree of concentration in the urban area of Greater Khartoum, but IBs existence in the backward and rural regions is bigger than that of other commercial banks. This might be interpreted as a contribution to monetising the traditional sector and would therefore have a favourable impact on economic growth.

IBs dominate 62% of the paid-up capital of the banking system. An introduction of IBs as a joint-venture between the Sudanese nationals and foreign subscribers has benefited the economy, since the experience of introducing IBs attracted foreign resources and mobilised the stagnant local resources. They are characterised by high degree of capitalisation in contrast to other operating banks

IBs have nearly 20% of total deposits of the banking system. A contribution which could be attributed to IBs is that they attracted new depositors to banking business, those who in the past have eschewed dealings with conventional banks on religious grounds. Moreover, IBs attracted new small depositors as well (Chapter VII).

IBs maintain their market share thanks to, religious considerations, the competitive services they provide and to the wide spread of services relative to conventional banks. One finding which is not favourable to IBs is that customers were not attracted by higher return or by greater access to credit facilities. However, the religious element is found to be dominant even in distribution of deposits among different accounts.

The investment account is an important component of total deposits of IBs. Depositors of course put their savings in this account for the purpose of investment. The larger the share of investment deposits in total deposits, the longer the maturity of deposits, and the bank is more able to deploy them in long-term investments.

The research findings support the opinion that IBs' customers are willing to take risk with a bank, and can accept loss of part or all of the value of investment deposits. More important is the finding that the religious element has no greater impact on the willingness of customers to take risk than the economic factor has. Thus, customers are willing to take risks even on an economic basis.

Customers who prefer investment (*PLS*) accounts are willing to accept variable (uncertain) rates of return. Moreover, customers accept uncertain rates of return not only for religious reasons but also on economic grounds.

One of the factors affecting the banks' market share is the level at which they carry out their services. If IBs are capable of serving clients efficiently, they will attract more customers and hence positively influence their market share. IBs are found carrying out their services fairly adequately, but no better or worse than is the case with conventional banks.

IBs still do not extend credit facilities to a large number of customers; and even the few who use these facilities are not from the low-income depositors, the group

which is in desperate need of help. The majority of IBs' depositors are ignorant of conditions and policies on credit facilities.

IBs did affect customers' knowledge through the relatively widespread of services; a finding which is in favour of IBs playing a role in monetising the economy.

It would appear that the effort of managers to raise and maintain deposits is still not very effective. This limits the market share of IBs.

The attitude of authorities through the public policies (in particular the credit policies) has affected all banks in general and IBs in particular. Thus, credit policies have firstly affected the deposit structure of IBs and secondly the degree of utilisation of these deposits. Both types of impact have direct implications for the market share of IBs.

Like other IBs elsewhere, those in the Sudan do not undertake interest-based transactions. This is, however, an obstacle to the growth and expansion of IBs since they neither keep deposits with interest-based banks, nor do they hope for interest-based banks to hold funds with them. Thus, they lose a great part of the market share that were they to pay an interest rate.

One of the elements liable to affect the market share of IBs is the way they manage their portfolio. The issue of portfolio management is important and has not yet been solved by IBs in the Sudan.

There is no specific criterion followed by IBs in determining the rate of return on deposits, therefore the rate of profitability of investment deposits varies from one bank to another.

IBs have been fair with depositors versus shareholders because they follow the practice of deducting the legal and general reserves from net profits (of shareholders) and not from gross profits (of depositors and shareholders). This practice is fair since depositors have no stakes in these banks.

12.2.2 IBs: a contribution to development financing

When IBs were founded, it was declared that their objectives was to participate in development. These objectives imply a direct and specific responsibility on the

part of IBs to play an effective role in social and economic development by adopting methods of finance that are different from those of traditional banks.

What IBs have accomplished on the side of development financing, is still far less than what was first declared and expected. It is apparent that IBs have concentrated on short-term activities to maintain their existence in the market. IBs wished to convince their depositors and shareholders that they were capable of generating high profits and returns. However, this policy should be a transitional and not a permanent one.

Although IBs have mobilised fairly adequate financial resources, the fact remains that they still concentrate their investments on short-term commercial activities as do other commercial banks. On the other hand, the medium-and-long-term financing was for the most part participation in capital of banks and financial institutions and subscriptions in subsidiary companies.

What also attracts attention is the direction of financial resources to investment outside the country.

It is found that in the Sudan inadequate finance is crippling industrial and commercial development. Most, or all, productive units lack finance. Almost, all the financial institutions concentrate on financing credit-worthy firms, especially those in urban areas, and extend little credit to the financially-starved productive units, particularly those in the rural areas. Financial institutions neither promote new investment opportunities nor encourage applicants for finance to come forward and provide them with advice and extra services. The situation is more or less the same for IBs.

Why the contribution to medium-and long-term financing is insignificant?

Regarding closely the liability side of IBs, they are capable of financing investment projects of a long-term nature. This implies that IBs are financially able to invest in productive projects, and that these are not problems in this respect if other obstacles are removed. Managers of IBs have indicated that when they wished to invest in productive projects, they were not faced with illiquidity problems.

The demand for medium-and-long-term credits is in general found to be low since customers were constrained by the conditions specified by IBs for granting credits, such as the short repayment and grace periods, high profit margins as well as the type of guarantee required by IBs. Hence, the strength of demand for such type of credits is likely to be weak.

On the other hand, the character of demand for medium-and-long-term investments is such that customers refrained from applying for productive investments and tended instead to go for trade finance. There are two reasons for customers preference for trade finance rather than productive loans: (a) customers are not prepared to take risk and (b) they lack adequate capital.

Thus, part of the insignificant contribution to medium-and-long-term finance by IBs might be accounted for by the inability of customers to fulfil some conditions specified by IBs for credits and the customers' tendency to avoid risks and prefer trade finance.

The attitude of IBs' managers is not conducive to medium-and-long-term investments. The lack of expert staff; the concentration on investors in urban areas; the great emphasis on collateral without differentiating between the nature of the proposed projects; the shifting of resources from rural to urban areas and the emphasis on the profitability of a project, all these are factors which influence IBs' managers to sponsor productive investments.

So far as the effect of public policies on the role of banks in general and IBs in particular, in development financing, these policies have negatively affected this role. The government's policies have been consistently protectionist, and therefore bankers in particular, and industrial entrepreneurs in general, have adopted conservative behaviour.

It is, of course, not only the attitude of authorities which has affected the contribution of all banks to the financing of productive projects; structural problems of the Sudanese economy have also hampered the role of banks in this regard. To all managers of IBs, structural bottlenecks in the economy are hindering investments in productive projects to a great extent.

Islāmic methods of finance require information on clients and the market so that these methods might adequately be applied. This requirement is particularly important in the case of medium-and-long-term investments. Therefore, some IBs' managers are discouraged from financing some productive investments either because of a lack of information or because the traditional form of Islāmic method of finance is not attractive to some borrowers.

12.2.3 FIBS and financial assistance to crafts firms

In general, a definition of what constitutes a small firm is still lacking. In the Sudan there is no specific definition for a small firm, but some institutions used to classify smaller firms according to total investments and the number of employees.

A contribution of the Sudanese industrial sector to the GDP has been fluctuating and declining overtime. This is attributed to the problems facing the Sudanese economy in general and the industrial sector in particular.

Development of SSIs in the Sudan was adversely affected by the industrial policies since the early 1960s.

Smaller enterprises comprise 95% of all industrial firms in the Sudan. Almost all small enterprises are privately owned since the firms need smaller amount of investment, and the technology used is simple.

Regional distribution of SSIs show that more than 50% of smaller firms are located in Khartoum and the Central Region due to some reasons such as, for instance, the relatively sufficient availability of infrastructure and easy access to raw materials.

Large firms records with regard to employment and output exceeded that of SSIs because the government invested in the industrial sector and it encouraged large-scale investments by granting concessions and tax exemptions.

SSIs appear to need less capital compared with LSIs, and are characterised by low cost to create jobs, high value added and output/capital ratio.

Financial facilities provided by the commercial banks, and the pattern of allocating these facilities provide evidence that smaller firms in the Sudan are at dis-

advantage in terms of type, volume and conditions of financing. Thus commercial banks partly contributed to the small business finance gap in the Sudan. Moreover, there exists a large volume of commercial banks' financial resources which remain unutilised, and this finding is indicative of the conservative attitude of banks towards small business financing. Banks have been highly security-conscious and profit-oriented.

Financial practices of even the development financial institutions violated the main objectives of setting up these development bodies as they have been, as well, both security-oriented and profit-conscious.

Regarding the financial institutions policies, there is a small business 'policy gap'. In addition to this, owners of small firms have indicated that there is a lack of information and advice about the financial facilities available in banking system.

The categorical distribution of crafts units in the Greater Khartoum reveals that the two important categories are the blacksmiths and carpenters. A large number of people depends on the crafts sector to maintain their living. The majority of craftsmen in the Sudan started work in their thirties, and the majority have been practicing their profession for twenty years and more. Despite the increasing number of educated people among craftsmen, still the relationship between the type of education (and its level) and the profession is not strong. Most of craftsmen came from rural areas because they find better and favourable conditions for work in urban areas. Though the crafts activity is old, a great development in the number of crafts units occurred during the eighties; despite the increase in number, there has been no new invention, and more recent start-ups have copied those who have already established workshops.

The crafts sector has great potential for employment. This is in fact important particularly in the case of the Sudan where unemployment among school-leavers and even among the well educated people is increasing, and the public sector is totally unable to create new jobs.

The fieldwork analysis shows that there is a variation in an employment capacity even among crafts units. Blacksmiths, carpentry and welding and fitting are the professions which absorb more labourers.

The fixed capital of the sector is in the form of buildings, machinery, equipments and raw materials. The survey findings disclose that there is a similarity in the size of fixed investments for crafts categories. However, both blacksmiths and carpenters are characterised, among other categories, by a relatively high fixed investment. There is a noticeable increase in the current fixed investment of crafts units, which means that the sector has a potential for growth and expansion.

Products of the crafts sector are varied, and are characterised as being cheap and at different prices. More important is the fact that the sector has contributed in substituting imported products with local products such as spare parts, metallic compounds, furniture and other products that were hitherto imported.

The crafts sector uses a fairly large proportion of imported raw materials. Crafts units depend to a greater extent on buying raw materials either from their own savings or borrowing. The sector lacks financial support to obtain its raw materials.

There is a finance gap for crafts firms. The majority depend to a lesser extent on the branch for providing funds, the frequency of applying for the credit is low, the credit received did not increase for the majority of craftsmen and the shortage of finance is a hindrance to growth for more than 90% of crafts units.

There is a 'Sudanese' Bolton gap facing the crafts sector. The crafts branch does not help in this regard. Craftsmen have no idea about other sources of finance for smaller firms, and they ignore the banking credit conditions.

Concerning the advice on technical, managerial or financial matters, the field-work results have shown that there is a lack of information and advice; the majority of craftsmen did not hear at all of any bank or a business firm giving advice services.

Investments by the crafts branch have been increased over time. The credit is deployed to import machinery, equipment and raw materials from abroad as well as providing them from the local market. Investigation of loans extended by the branch reveals that the size of a single loan is generally small even though the cost of controlling and administering these loans is relatively high. The majority of crafts firms are under-financed. Despite that, the branch exceeded all other institutional sources of finance to crafts firms. Both the number of firms assisted

and the volume of assistance exceeded that given by other banks and financial institutions.

In terms of costs of finance, the crafts branch conducts its lending at lower costs for crafts, when compared with other financial institutions. In this way, crafts units have more access to get credit from the branch than to get a loan elsewhere. It is also uncovered by the survey that the crafts units supported by the branch have an average lower capital investment than the firms assisted by other financial institutions.

There is an insignificant share of 'equity' finance in the total loanable funds of the branch. It would seem that the branch accommodates the crafts units with working capital only rather than the start-up capital or innovative capital, i.e., equity finance. In this regard, it is found that craftsmen prefer *murābaha*, as a form of trade finance, rather than *mushāraka*, as equity finance.

The crafts branch have helped in bridging part of the finance gap facing crafts firms, but still the crafts sector is under-financed. The cause for this has been tackled with regard to the conditions stipulated for credit extension by the branch. An empirical investigation proves that with the exception of grace period condition, other stipulations are flexible and have not influenced craftsmen in deciding to seek increased credit.

The state of under-finance exists for craftsmen as there are some problems crippling firms and discouraging them from taking loans from the branch. Moreover, the condition of paying 25% of the loan as a first instalment is, in most cases, beyond the capacity of craftsmen. Hence, their demand for credit is low.

On the other hand, it is found that the following factors affect the decision of the branch to give part of the loan needed by the craftsmen or to cancel the application altogether: (a) the past record of a craft units; (b) the number of loans the unit received from the branch, its performance and the size of deposits it keeps with the branch; (c) the availability of information about the firm and availability of commodity the craftsman needs; (d) the type of activity of the crafts unit and the availability of guarantee.

It is found that the majority of assisted firms have gained from their business relationship with the branch, benefits in terms of an increase in employment and production levels as a result of availability of more (external) finance from the branch.

There are no incentives or concessions for investments in the crafts sector. Public corporations and private firms are not directed to support the sector; and the government's effort to attract the foreign financial and technical assistance to the sector is limited.

Most of the crafts units face other problems such as the electricity supply cuts and an inadequate supply of fuel or wood energy, the lack of efficient transport network and other basic services.

12.3 Some Recommendations

IBs are required to participate more in improving the productivity of the existing capital by extending their services, especially to the rural areas, and by improving access to equipment and markets by extending funds to those in traditional sectors to finance more productive inputs. In this respect, the purpose of IBs, as financial institutions in an underdeveloped economy, would be to provide collecting points for savings of a relatively small average amount from a large number of individual sources.

Since the Sudan is a poor country, there is a great need for IBs and for other financial agencies to collect and invest the savings of the people and institutions within its borders. It should be emphasized here that, it is not enough just to extend services to rural areas, mobilising savings there and placing them in investment activities outside these rural areas. Not only should the spread of IBs improve the interregional flows of funds, it should also reduce the disparities in the cost of borrowing, and invest the mobilised resources in the rural areas.

It is found that IBs use deposits of branches in rural areas in one way or another to fund investments in urban areas. This 'export' of rural area savings will have an adverse effect on the growth rate of these backward areas. In this respect one might recommend that IBs should adopt a growth from below policy,

with more emphasis on the financing of small-scale economic activity in industry and agriculture. They should open branches in rural areas so that every branch could carry out specific functions, and this would activate stagnant potentialities for growth.

The growth-from-below policy should be through the branch banking expansion rather than unit banking expansion. Branch banking has the advantage of widening the resource base which enables sudden emergencies to be dealt with more easily, diversifying their risks to a greater extent. Hence IBs could be less susceptible to difficulties.

IBs are found depending to a great extent on religious commitments of depositors to maintain their market share, and to a lesser extent on the competitive and widespread of services. However, in order to avoid endangering their market share, IBs should attract more customers through extending a wide range of credit facilities and realising high returns on investment deposits. This is quite important since the majority of depositors are from low-income groups.

If IBs' deposits are to be of a predominantly long-term nature, and if they are to be in a better position to undertake more long-term investments, IBs should encourage their customers to have investment accounts. Customers (depositors) with IBs are found prepared to accept loss on the value of investment deposits and the uncertainty on return. So, IBs should encourage this attitude by customers but they should work to give reasonably high return on their deposits. In other words, IBs should build their bank-customer relationship on economic rather than religious considerations.

IBs should offer different investment accounts characterised by different risks and depositors should have a say on how these savings are allocated. Moreover, IBs should provide for the motives of depositors who seek an investment in lesser risky and short-term projects, and the motives of shareholders who seek more riskier and long-term projects. Thus, money from depositors should not be pooled with that of shareholders.

The monetary and credit policies followed by the Bank of Sudan have become very stringent. They have crippled the size, form and utilisation of deposits with

banks in general and IBs in particular. In this regard, the recommendation is that the credit policy should be flexible with banks so long as they direct more finance to certain economic sectors or activities in line with the objectives of the development plan of the country.

IBs should find financial instruments and innovations which enable them to deal with other banks, so that the former can keep with the latter or hold for them deposits, on interest-free basis. This remains a question for the managers and *Shari'a* Supervisory Boards of IBs.

The conditions of opening up accounts with a bank, especially the investment account, should be made easy particularly for rural savers who are poor compared to those in urban areas. IBs should give rural savers some incentives and privileges, even in kind. In this way, IBs would mobilise more of stagnant resources in rural areas instead of competing with other banks for the same group of depositors in urban areas.

The Sudanese IBs came to existence with some objectives. These objectives imply a direct and specific responsibility on the part of IBs to play an effective role in social and economic development. It is apparent that IBs have concentrated on short-term commercial activities to maintain their existence in the market. There can be no doubt that the policy of achieving high profit is important for the success of IBs or any profit-making institution, but this should not be a permanent policy. The policy of convincing depositors and shareholders should be transitional, and IBs should redirect their objectives towards other real productive activities.

There can be no doubt that the development goals adopted by IBs coincide with the needs of the national economy. IBs are required to extend finance to small investors, producers, craftsmen and small industrialists, particularly those in rural areas. However, as mentioned above, regarding the liability side of IBs, they are capable of financing investment projects of a long-term nature.

The research findings show that demand for medium-and-long-term investments was constrained by the short repayment and grace periods and by high profit margins; they were also hindered by the type of guarantee required by IBs. If IBs wished to encourage customers and increase the demand for their facilities,

these conditions should be relaxed so that customers would be able to fulfil them. Moreover, IBs should increase their shares in these projects because customers showed that they lack capital to undertake this kind of productive investments.

If demand for medium-and-long-term investments is low, IBs should be 'supply leading' rather than 'demand following'. They do not have to concentrate on short-term self-liquidating commercial loans; rather, they should establish close ties with productive investors, especially those in rural areas, and provide funds for fixed investments as well as for working capital. The 'supply-leading' policy is so important, not only because demand for corporate financing is low, but also because IBs are able to finance this type of investment.

IBs, in this concern, have to maintain sound banking assets which are 'self-liquidating' in the sense that customers are thought sure to be able to repay. However, to prevent difficult liquidation, IBs have to maintain the total volume of their lending.

IBs lack skilful staff to undertake feasibility studies for medium-and-long-term projects. A provider of long-term capital is concerned not so much with the balance sheet position as with the long-term earning capacity of the borrower. Assessment of the earning capacity is very different task from assessment of the current balance sheet position. It calls for a long view of markets.

Assessment of these factors can be undertaken reasonably by a larger group of specialists. Therefore, IBs need feasibility studies units, with experts specialising in one or more industries. IBs should provide finance not only for working capital but for fixed investment, and not only for trade (*murābaha*) finance, but for finance on a participation basis.

The government's policies towards banks have been consistently protectionist, especially since 1978 when the IMF policies were applied to curb the total credit in the economy. These policies should be relaxed so that IBs, among other banks, should have some freedom to deploy their resources.

Islāmic methods of finance require information on clients and the market so that these modes might adequately be applied. IBs should have their informa-

tion units within the investment departments to help in providing the necessary information.

The effective and efficient use of resources is important for the Sudanese economy as it faces economic and financial constraints. The economy lacks capital, savings and institutionalised credits for development, a developed infrastructure and skilled labour. All these suggest the need for an appropriate industrial strategy fitting the critical situation of the economy. In this respect, SSIs are important, especially with the disappointing result of the Sudanese experience with large-scale industrial strategy. The Sudanese economy has been experiencing a low saving ratio on the part of investors, inadequate capital for investment and inadequate infrastructure and low technical levels. These and other factors give prominence to SSIs. The government should turn attention to them and solve their problems. Of particular significance are the financial constraints facing SSIs.

The government is deficient in designing a policy to develop the sector. However, a general framework of the public policy towards the sector could be based on the following:

(1) The government's industrial strategy should concentrate on the SSIs similar to crafts firms where investment needed is small and it is labour-intensive.

(2) As the SBA (see Chapter X) does in helping smaller firms to obtain government contracts, public and government corporations should meet their requirements from the products of the sector.

(3) The policy should enhance forward and backward linkages among industrial categories on the one hand and between the industrial sector and other sectors on the other hand.

(4) The policy towards the sector should be complementary to the comprehensive industrial strategy, so that it continues in the medium and long-term.

(5) The government has not yet set-up a separate body to sponsor the crafts sector. It is only in early 1989 that the Ministry of Industry has established a small unit to supervise the sector. The director of the unit whom the author met in March 1989, has revealed to us that the unit has not yet started proper working,

and not equipped enough to sponsor the crafts sector. However, this unit is a move towards helping the government to design a policy for the sector. The unit could be supported to design a policy and to be responsible for the execution and follow-up of government policy towards the sector. As the SBICS do (see Chapter X), this unit could be enhanced to provide technical and managerial consultancy to craftsmen, training programmes and advice on financial affairs and information on financing sources.

(6) The government could, perhaps, help in bridging the finance gap by taking into consideration financial needs of the sector when the Central Bank designs monetary and credit policies. The Bank of Sudan could ask banks to deploy a fairly significant percentage of their financial resources into the crafts sector. The body responsible for the sector could also help in this respect by obtaining external aids, both technical and financial.

(7) Whilst FIBS relaxes the condition of guarantee for craftsmen, the majority of crafts units lack the adequate guarantee to obtain institutional finance. The government should work out a programme to arrange for the provision of guarantees as the government in the U.K. does through the LGS, and as the SBA (U.S.A.) does to enable smaller firms to have greater access to institutional credits, (see Chapter X).

(8) The provision of raw materials to the sector is of paramount importance, because the crafts units use raw materials in smaller quantities and they cannot afford import costs or the costs of buying larger quantities and storing them. The government should cater for this problem. Also the need of craftsmen for training, technical and managerial advice and marketing is by no means less important.

The role of FIBS in financing crafts units may be insignificant, and it may need revision and enhancing. The initiative is constructive and it is a brave move towards a sector that has remained for a long time unknown to the banking system. The government should appreciate this experience and enhance it practically by, for instance, allowing banks to deploy their deposits which are standing idle with the Central Bank, so that funds allocated to crafts sector should not be included in the ceiling limits specified by the Central Bank for these banks.

As for FIBS, it should revise the past experience of financing crafts units and expand it so that the bank should concentrate on equity finance rather than trade finance, and on fixed investments rather than working capital. The bank could, and is recommended to, have branches for crafts in local towns, especially in the backward regions of the country.

Appendix A

Depositors Questionnaire

Name:

Q1. Do you have an account with a conventional bank?

☐ Yes

[] No

Q2. If yes, do you have an account first with a conventional bank or an Islāmic bank?

Q3. Why do you have an account with an Islāmic bank?

☐ Religious reasons

[] Competitive services

[] High returns

[] For more access to loans

[] Spatial reasons (convenience)

Q4. Which type(s) of account(s) do you have with an Islāmic bank?

[] Current account: [] Local

[] Foreign

☐ Savings account: ☐ Local

[] Foreign

☐ Investment account: ☐ Local

[] Foreign

Q5. You have no contractual right to withdraw your fund before an end of a well-defined period. Does this affect your decision to deposit with the bank?

☐ Yes

[] No

Q6. You are exposed to risk of nominal losses when you have investment account with an Islāmic bank. Does this affect your decision?

☐ Yes

[] No

Q7. Which one do you prefer, an investment account with an Islāmic bank or a time deposit with a traditional bank?

[] Investment account

☐ Time deposit account

Q8. If you prefer a time deposits account, which of the following is important to you?

	Not important	Important	Greatly important
Guarantee of deposit value			
Guarantee of fixed rate of return			

Q9. Indicate how effectively does the Islāmic bank provide services?

☐ Poor ☐ Fair ☐ Good ☐ Excellent

Q10. (a.) Which of the following banking services you make use of?

☐ Provision of different accounts services ☐ Letters of credit and guarantee facilities

☐ Transfer of money and currency exchange ☐ Borrowings from the bank

Q10. (b) If you restrict yourself to only one of these services, what are the reasons?

☐ Not aware of other services ☐ I do not need them

☐ I'm unable to meet the conditions of these servivces

Q11. Are you aware of the bank's policy and services in relation to credit facilities?

☐ Yes

☐ No

Appendix B

Borrowers (Investors) Questionnaire

Name:

Q1. Do you deal with conventional banks?

☐ Yes

☐ No

Q2. Indicate the relative importance of each of the following credit conditions?

Conditions	Important	Not important
Repayment period		
Grace Period		
Profit Margins		
Type of Guarantee		
Freedom to use credit		

Q3. Show the length of repayment and grace periods of your loans?

Periods	Length of period (months)				
	1-2	3-6	7-9	10-12	Above 12
Repayment period					
Grace period					

Q4. What are profit margins on loans?

Profit margins (%)						
0-5	6-10	11-15	16-20	21-25	25	Above 25

Q5. To what extent is it easy for you to provide a guarantee?

☐ Easy ☐ Difficult

Q6. Would you indicate how efficient is the bank in providing its services?

☐ Bad ☐ Reasonable ☐ Excellent

Q7. For what purpose do you borrow money from the bank?

☐ Trade ☐ Agriculture ☐ Industry ☐ Transport

Q8. Apart from trade, do you undertake feasibility study to the bank for finance?

☐ Yes ☐ No

Q9. If yes, what type of investment project was not funded?

☐ Agriculture ☐ Industry ☐ Transport

Q10. Which of the following is a reason for you to prefer trade finance?

☐ High profit margins ☐ The high turn-over of capital in trade

☐ The low risk ☐ Inadequate capital for other non-trading investments

Q11. What a *PLS* method of finance do you use?

☐ *Murābaha* ☐ *Mushāraka* ☐ *Muḍāraba* ☐ Others (specify)

Q12. Does the bank impose the *PLS* method you deal with?

☐ Yes ☐ No

Q13. If no, what are the reasons for choosing a certain *PLS* method?

Q14. Is your business (financial) relationship with the bank growing?

☐ Yes ☐ No

Q15. Do you know the bank's policies regarding loans?

☐ Yes ☐ No

Q16. What size of loans do you usually apply for?

Loan size (000s LS)					
50-100	101-200	201-300	301-400	401-500	501-1000

Appendix C

IBs Managers Questionnaire

- First: The role of the management in savings mobilisation

✓ Q1. What are the methods adopted to raise savings knowledge?

✓ Q2. To what extent is the bank capable of encouraging small savers to save and invest?

Q3. Are there incentives to small depositors in a form of gratis loans or concessionary facilities to buy, say machinery, with nominal profits?

Q4. Is there a system adopted for offering a premium for long-term deposits?

☐ Yes

☐ No

✓ Q5 Depositors of investment accounts are exposed to risk, and depositors have no institutionalised influence on the management decision. Does the bank offer different investment accounts characterised by different risks?

☐ Yes

☐ No

Q6. How is the portfolio managed, are depositors' funds allocated in different, less risky, projects while shareholders' funds in another, high risky ones?

Q7. Indicate the relative importance of deposits of branches in rural areas in financing the banks' urban funding activities?

☐ Not important ☐ Important ☐ highly important

✓ Q8. What are the difficulties encountered in establishing branches in rural areas?

- Second: Investment and allocation of savings

Q9. Is there weak demand by successful entrepreneurs for participation financing because they do not wish to share the expected profits with someone else?

☐ Yes

☐ No

Q10. Could one say that it is not very attractive that the traditional form of Islāmic partnership financing gives the bank the right to interfere into the partner's? ☐ Yes ☐ No

Q11. What do you say about the shortage in financing seed capital for small and medium-sized enterprises?

Q12. IBs are said to be concentrating on financing domestic and international trade, and of some manufacturing projects in major cities while no much financing is available for small farmers and craftsmen outside big cities. How do you react?

Q13. The share of medium-and-long-term financing in total financing of IBs is regarded as low. If one goes beyond the short-term financing of working capital, the financing is provided not on the basis of participation but of leasing contracts. Would you agree?

✓ Q14. Indicate the relative importance of investment through customers, subsidiary companies and direct investment:

	Not important	Important	Highly important
Loans to Customers			
Subsidiary Companies			
Direct investments			

Q15. Indicate the relative importance of the following factors in affecting an allocation of funds in the above way?

	Not important	Important	Highly important
Limited credit ceilings			
Profitability			
Others specify) (a) (b)			

✓ Q16. Indicate the relative importance of the following in granting credits to customers?

	Not important	Important	Highly important
Collaterals			
Personal qualities of the client			

Q17. Indicate the relative importance of the rate of return from a productive project in hindering investment in that project?

	Not important	Important	Highly important
Rate of return from projects			

✓ Q18. Is there any problem from the side of funds to finance medium-and-long-term investments on a corporate basis?

- Third: The bank's relation with monetary and financial authorities

Q19. Are there special laws regulating IBs' operations?

✓ Q20. Are there facilities given by the Central Bank to conventional banks rather than to IBs?

Q21. Are there interest-free financing facilities extended by the Central Bank to IBs?

Q22. Is the bank liable to pay more taxes than a conventional bank due to differences in methods of finance?

- Fourth: The bank's relation with other financial institutions

✓ Q23. Is the bank involved in investing part of its capital abroad?

☐ Yes

☐ No

✓ Q24. If yes, what are the causes?

Q25. Is the management considering a more international approach for its business? ☐ Yes ☐ No

- Fifth: The bank's profits

✓ Q26. How do you calculate gross profits (of depositors and shareholders) and net profit (of shareholders)?

Q27. In calculating gross profits, do you deduct any income generated without a direct recourse to depositors' funds from the pool to be distributed between depositors and shareholders?

Q28. Are there any conditions for depositors to be entitled to profits such as a minimum contracted period and a minimum balance in the deposit account?

Q29. How do you take the legal and general reserves? Are they deducted from the gross profits or from the net profits?

Appendix D

Craftsmen Questionnaire

Name:

Q1. What is your place of birth? ☐ Khartoum ☐ Rural areas

Q2. What is your age (years)?

☐ 15-20 ☐ 21-25 ☐ 26-30 ☐ 31-35

☐ 36-40 ☐ 41-45 ☐ 46-50 ☐ Above 50

Q3. Are you married? ☐ Yes ☐ No

Q4. How many children do you have?

☐ 1-5 ☐ 6-10 ☐ 11-15 ☐ Above 15

Q5. How many years have you been as a craftsman?

☐ 1-5 ☐ 6-10 ☐ 11-15

☐ 16-20 ☐ 21-25 ☐ 26-30 ☐ Above 30

Q6. What is the level of your education?

☐ *Khalwa* ☐ No-school ☐ Primary school ☐ Intermediate level

☐ Secondary level ☐ University graduate ☐ Not stated ☐ Technical institute

Q7. Is there any relation between your education and your profession?

☐ Yes ☐ No

Q8. (A) Do you own the workshop? ☐

(B) Do you rent the workshop? ☐

(C) Do you part-own and part-rent the workshop? ☐

Q9. Do you employ any labour apart from yourself?

☐ Yes

☐ No

Q10. If yes, how many are they your relatives and how many are non-relatives?

☐ Members of your own family

☐ Other relatives

☐ Non-relatives

Q11. What was your start-up capital? (000s LS.)

☐ 1-5 ☐ 6-10 ☐ 11-15 ☐ 16-20 ☐ 21-25

☐ 26-30 ☐ 31-40 ☐ 41-50 ☐ 50-100 ☐ Above 100.

Q12. What is the current capital (000s LS.)?

☐ 1-5 ☐ 6-10 ☐ 11-15 ☐ 16-20 ☐ 21-25

☐ 26-30 ☐ 31-40 ☐ 41-50 ☐ 50-100 ☐ Above 100.

Q13. What is the size of your annual sales (000s LS.)?

☐ 1-10 ☐ 11-20 ☐ 21-30 ☐ 31-40

☐ 41-50 ☐ 51-100 ☐ Above 100.

Q14. What is the average percentage of the increase of sales?

☐ 1-5 ☐ 6-10 ☐ 11-15 ☐ 16-20 ☐ 21-25 ☐ Above 25 (%)

Q15. What kind of crafts activity do you practice in?

Q16. What are your non-banking sources of finance?

☐ Own-savings ☐ Borrowing from others

☐ Sharing others ☐ Taking money in advance from buyers

Q17. By how much do you depend on the crafts branch to finance you?

Promlems	Extremely bad			Slightly		
	5	4	3	2	1	0
(1)						
(2)						
(3)						
(4)						
(5)						
(6)						

Q27. Apart from financing, does the branch provide other services?

(Specify, if at all)

Q28. How long is the maturity of credits you received from the branch?

☐ 3-6 ☐ 7-9 ☐ 10-12 ☐ Above 12 (in months)

Q29. How long is the grace period?

☐ 3-6 ☐ 7-9 ☐ 10-12 ☐ Above 12 (in months)

Q30. How much are the profit margins you paid on the credits you received?

☐ 0-5 ☐ 6-10 ☐ 11-15 ☐ 16-20 ☐ 21-25 ☐ 25 ☐ Above 25 (%)

Q31. Which kind of guarantee do you usually provide?

☐ Personal gaurantee ☐ Real estate guarantee

☐ The relevant object you get from the branch ☐ No guarantee

Q32. Indicate the relative hardness to you of the guarantee required?

☐ Hard guarantee ☐ Easy guarantee

Q33. Indicate the relative importance to you of the following credit conditions?

Conditions	Essential			Not important		
	5	4	3	2	1	0
Maturity of repayment						
Grace period						
Profit margins						
Required guarantee						
Freedom to use credit						

Q34. How efficient is the branch in providing services?

☐ Bad ☐ Fair ☐ Excellent

Q35 Which of the following *PLS* modes you use in dealing with the branch?

☐ *Murābaha* ☐ *Mushāraka* ☐ *Muḍāraba* ☐ Hire-purchase

Q36 Is the branch imposing on you to choose a certain type of any of the above modes? ☐ Yes ☐ No

Q37. Which of the following factors affect your choice of the mode?

☐ Soft guarantee required ☐ Low profit margins I pay

☐ long repayment period ☐ All these factors.

Q38. Has the credit you got from the branch increased?

☐ Yes ☐ No

Q39 Are you aware of the banking services available at the branch?

☐ Yes ☐ No

Q40 Are you aware of the branch's policy and services in relation to credit facilities? ☐ Yes ☐ No

Q41. Have you considered various kinds of financial assistance extended by banks or other entities including governments?

☐ Yes ☐ No

Q42 Do you keep any systematic records on your costs of production, sales, revenuesetc.? ☐ Yes ☐ No

Q43 What is an approximate annual profit margins on your sales?

☐ 5-10 ☐ 11-15 ☐ 16-20 ☐ 21-25 ☐ Above 25 (%)

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